LIFO RECAPTURE ON C-TO-S CONVERSIONS:
FILLING THE GAPS AND AMELIORATING THE DEFICIENCIES OF SECTION 1363(D)

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Prior to the enactment of section 1363(d) in 1987, the conversion of a C corporation to S corporation status was, with rare exception,¹ considered to be a nonevent for tax purposes.

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²Section 1373(b) treats the making of an S election by a C corporation with foreign business operations as a “disposition” within the meaning of section 904(f)(3)(B)(i). Under section 904(f)(3)(A), the disposition of a foreign business operation generally triggers the immediate recognition of income to the extent of any unrecaptured “overall foreign losses” that the corporation has previously offset against its U.S.-source income.

Prior to the enactment of section 1371(d) in 1982, a C corporation making an S election was required to recapture its unearned investment tax credits unless all of the corporation’s shareholders agreed to assume personal liability for any future recapture taxes. Reg. § 1.47-4(b)(1); Tri-City Dr. Pepper Bottling Co. v. Commissioner, 61 T.C. 508 (1974) (upholding the validity of Regulation section 1.47-4(b)). The Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669, effectively repealed this
None of the gain or loss built into the value of the converting corporation’s assets was recognized, and its tax attributes, including the basis and holding period in its assets, its earnings and profits account balance, and its accounting methods, continued unchanged. The policy of permitting nontaxable C-to-S transformations was and is grounded in the overall federal policy of promoting the formation and growth of small businesses, in part by allowing small businesses to

regulation by providing that the filing of an S election was not a recapture event and that the electing corporation would itself be liable for any tax upon a subsequent recapture of the credit. I.R.C. § 1371(d)(1), (2).

Section 1378(a), however, requires an S corporation to use a “permitted year,” which is usually, but not always, a calendar year. A fiscal-year C corporation will generally be required to change its taxable year to a calendar year for its S election to be effective. The Service may, however, approve the use of a fiscal year where certain conditions are satisfied. See infra note 276.

Loss and credit carryforwards from a converted corporation’s prior C years are also preserved, but can be used by the S corporation only to the extent provided in section 1374(b)(2) (net operating loss and capital loss carryforwards from C years can be used to offset the corporation’s recognized built-in gains) and section 1374(b)(3) (business credit carryforwards and minimum tax credit carryforwards from C years can be used to offset corporate-level taxes otherwise imposed on the corporation’s net recognized built-in gains under section 1374(a)). See infra note 15. See also St. Charles Inv. Co. v. Commissioner, 232 F.3d 773 (10th Cir. 2000), rev’g 110 T.C. 46 (1998), where the Tenth Circuit held that an S corporation that had disposed of certain of its rental properties at a loss was entitled to deduct related suspended passive activity losses it had previously incurred as a C corporation. The court held that section 1371 was inapplicable because (1) section 469(b) states that “[e]xcept as otherwise provided in this section,” such losses are a deduction “allocable to [the] activity in the next taxable year”, and because (2) this “plain language” of section 469(b) precluded the application of section 1371. St. Charles Inv. Co., 232 F.3d at 776. The court concluded that the “except” language functioned like a “‘traffic cop’ preventing any provision of the Code outside of section 469 itself” from interfering with the operation of section 469(b). Id.

“operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties.”

For many, perhaps most, C corporations, treating the C-to-S conversion as a taxable event at the corporate level, the shareholder level, or both, would present a formidable obstacle to electing Subchapter S.

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise . . . .

4President Eisenhower’s Budget Message of January 21, 1954, 100 Cong. Rec. 567, 571 (1954). The Eisenhower Administration’s first attempt to enact the provisions that subsequently evolved into Subchapter S was unsuccessful. In 1958, the Senate Finance Committee overrode the objections of the House Ways and Means Committee to enact Subchapter S as part of the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 64, 72 Stat. 1650. The stated goals of these provisions were to permit businesses “to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence[s]” and to provide benefits to small businesses by removing the double tax on distributed earnings and by allowing their shareholders to use corporate losses to offset their personal income. S. Rep. No. 85-1983, at 87-89, 216-26 (1958), as reprinted in 1958-3 C.B. 922, at 1008-10 (general explanation) and 1137-47 (technical explanation).


With the focus in Washington on deficit reduction, it is easy to single out C to S conversions as a convenient source of revenue. Indeed, the passage of a LIFO recapture rule by RA ’87 is the first intrusion on previously untraveled territory. Following closely behind, the TCA would dramatically impose a stiffer toll charge for converting to S status. After the TCA, it would not be too great a leap to envisage the C to S conversion as a deemed asset sale . . . [followed by] a deemed liquidation, resulting in full double taxation. At such point,
The Revenue Act of 1987, which added section 1363(d) to Subchapter S, carved out a limited exception to this nonevent,

the costs associated with converting to S status could be so severe as to be impractical . . . .

[T]reating a C to S conversion as a deemed asset sale or liquidation is totally inconsistent with the purpose behind the original enactment of Subchapter S and its thirty-year history in the Code . . . . [To do so would result in] many corporations [being] locked into the double tax system under Subchapter C.

Nevertheless, such treatment has been proposed. The Clinton Administration’s budget proposals for fiscal years 1997 through 2000 proposed that S elections by large C corporations (i.e., corporations having a net worth in excess of $5 million as of the date of their conversion to S status) be treated as deemed liquidations, taxable at both the corporate level and the shareholder level. (Similarly, under these proposals, a large C corporation that converted into a regulated investment company or a real estate investment trust would have been required to recognize the net gain built into the value of its assets as of the date of its conversion.) See, e.g., STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL, 244-47 (Comm. Print 1999); TREASURY DEPT., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS, 101-02 (1998).


Most recently, however, Congress has enacted amendments designed to “modernize the S corporation rules and eliminate undue restrictions on S corporations in order to expand the application of the S corporation provisions so that more corporations and their shareholders will be able to enjoy the benefits of subchapter S status.” H.R. Rep. No. 108-548 at 128 (2004) accompanying the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

Section 1363(d) was added by section 10227 of the Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330. At the time this new section 1363(d) was enacted, the Code already contained a section 1363(d) (which generally required S corporations to recognize gain on the distribution of appreciated property). With the revision of section 336 in 1986, old section 1363(d) became deadwood and it was belatedly and retroactively repealed by section 1006(f)(7) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3407.
nonrecognition treatment of C-to-S conversions.\textsuperscript{7} Section 1363(d) requires any C corporation that uses the “last-in, first-out” (LIFO) method to account for one or more of its inventories and that elects S status, to recognize the “LIFO recapture amount” built into its LIFO inventories as of the end of its last tax year as a C corporation. The “LIFO recapture amount” is the excess, if any, of the inventory’s value determined under the “first-in, first-out” (FIFO) method over its actual LIFO value.\textsuperscript{8} This amount is included in the converting corporation’s ordinary gross income on its final C corporation income tax return, and the resulting incremental income tax is

\textsuperscript{7}Section 1363(d) applies to any C corporation that made an S election which was effective after December 17, 1987 (or after January 1, 1989 if, on or before December 17, 1987, either the corporation’s board of directors had adopted a resolution to make an S election or the corporation had requested a ruling from the Service in which it expressed an intent to make an S election). Revenue Act of 1987, Pub. L. No. 100-203, § 10227(b)(2), 101 Stat. 1330.

\textsuperscript{8}Stated differently, the LIFO recapture amount is the cumulative net amount of gross income that the converting corporation has deferred by using the LIFO method, rather than the FIFO method, to account for its inventory. The LIFO recapture amount is generally synonymous with the accounting term “LIFO reserve.” However, although it is possible for a taxpayer to have a negative LIFO reserve (i.e., LIFO value exceeds FIFO value), the LIFO recapture amount cannot be negative. I.R.C. § 1363(d)(3); Rev. Proc. 94-61, Q&A No. 4, 1994-2 C.B. 775. Thus, in the unusual case where the corporation’s LIFO value exceeds its FIFO value, the LIFO recapture amount is zero and the converting corporation is not permitted to reduce its gross income for the negative LIFO reserve.

The FIFO value of the inventory is determined by using the “retail” method if the corporation uses the retail LIFO method to account for its inventory in computing its regular taxable income, or by using the “lower-of-cost-or-market” method if it does not. See infra note 130.

For nonaccountants, the use of the term “value” instead of “basis” can be confusing. By convention, the terms “LIFO value” and “FIFO value” refer to the tax basis (or, when used in the context of financial reporting, to the book value) of the inventory and not to the retail or wholesale value of the inventory.
payable in four interest-free annual installments, commencing with the due date for its final C corporation return. The statute also provides for the converting corporation to increase the tax basis of its LIFO inventories to reflect its recognition of this income. LIFO recapture under section 1363(d) does not terminate the converting corporation’s LIFO election.⁹

Regulations promulgated in 1994 extend the application of section 1363(d) to C corporations that transfer LIFO inventory to a new or existing S corporation in certain nontaxable carryover-basis transactions.¹⁰ Recently finalized regulations further extend the reach of section 1363(d) by overturning the decision of the Eleventh Circuit in Coggin Automotive Corp.¹¹ to require LIFO recapture where the LIFO inventory is held indirectly by a converting C corporation through one or more partnerships or limited liability companies.¹²

A. Historical Context

⁹The fact that the converting corporation will increase its tax basis, but not its book value, in the LIFO inventory will likewise not be considered a violation of the LIFO “conformity requirement” of sections 472(c) and (e)(2). See infra note 39; Rev. Proc. 94-61, Q&A No. 1 & No. 3, 1994-2 C.B. 775.

¹⁰Reg. § 1.1363-2(a)(2).

¹¹292 F.3d 1326 (11th Cir. 2002), rev’g 115 T.C. 349 (2000).
Section 1363(d) is part of the built-in gains tax regime of Subchapter S that includes section 1374. Section 1374 was enacted in 1986 as part of a comprehensive statutory overhaul that was designed to purge all vestiges of the so-called General Utilities doctrine\(^3\) from the Code. Subject to several exceptions, limitations, and refinements, section 1374 imposes a flat 35% corporate-level tax\(^4\) on the “net recognized built-in gain” of an S corporation for any tax year beginning in the ten-year recognition period.\(^{15}\) The “ten-year recognition period”

\(^3\)Reg. § 1.1363-2(b).

\(^4\)Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). The General Utilities doctrine was repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. Prior to its repeal in 1986, the statutory manifestations of that doctrine had enabled C corporations to permanently avoid income tax liability on part or all of the gain built into the value of appreciated assets that they disposed of in certain sales (under pre-1986 section 337) and distributions (under pre-1986 sections 311 and 336).

\(^5\)The tax is imposed at the highest rate specified in section 11(b). I.R.C. § 1374(b)(1). Taxes imposed under section 1374 are subject to an estimated tax requirement. I.R.C. § 6655(g)(4).

\(^6\)Generally stated, a “built-in gain” is the excess of an asset’s fair market value over its adjusted basis as of the effective date of the S election (or as of the date of the asset’s acquisition by an S corporation from a C corporation in a nontaxable carryover-basis transaction described in section 1374(d)(8)). A “recognized built-in gain” is any built-in gain that is recognized during the ten-year recognition period in a transaction that is treated as “sale or exchange” for federal income tax purposes. I.R.C. § 1374(d)(3); Reg. § 1374-4(a)(1). However, section 1374(d)(3) requires that the entire amount of any gain recognized on the disposition of any of the corporation’s assets within the ten-year recognition period be classified as a built-in gain and taxed under section 1374 unless the taxpayer can establish that it did not own the disposed asset on the first day of the ten-year recognition period or that the gain built into the disposed asset as of that date was less than the amount of gain realized on its subsequent disposition. Consequently, identifying and valuing the corporation’s tangible and intangible assets as of the date of a C corporation’s conversion to S status is crucial in limiting the application of section 1374.

A “recognized built-in loss” is any built-in loss that is recognized during the ten-year recognition period in a sale or exchange of an asset, but only if the corporation can establish that the asset was held by the corporation on the first day of the ten-year recognition period, and only to
the extent that it can establish the that the loss does not exceed the loss built-into the asset as of the beginning of the recognition period. I.R.C. § 1374(d)(4). See also Regulation section 1.1374-9 (“Anti-stuffing rule”).

See section 1374(d)(5) and Regulation section 1.1374-4 for the treatment of other built-in income and deduction items.

As noted above, section 1374 also applies to any net recognized built-in gains attributable to assets acquired by an S corporation in any nontaxable carryover-basis transaction in which the S corporation determined its basis in some or all of the acquired assets by reference to a C corporation’s basis in such assets. I.R.C. § 1374(d)(8); Reg. § 1.1374-8, -8T. Nontaxable carryover-basis transactions include liquidations of 80%-controlled subsidiaries under section 332 and asset acquisitions that qualify as reorganizations under section 368(a)(1)(A) (statutory merger or consolidation), section 368(a)(1)(C) (stock-for-asset acquisition), section 368(a)(1)(D) (transfer of assets to one or more controlled corporations), and section 368(a)(1)(G) (transfer of assets to one or more corporations in a bankruptcy or insolvency proceeding under a court approved reorganization plan).

Assets acquired by an S corporation in a nontaxable carryover-basis transaction must be tracked on a transaction-by-transaction basis and on an asset-by-asset basis. Reg. § 1.1374-8(b). Where assets are acquired in a nontaxable carryover-basis transaction from another S corporation that is itself subject to section 1374, section 1374 will continue to apply with respect to the acquired assets, but only for the balance of the transferor’s ten-year recognition period. I.R.C. § 1374(d)(8); Announcement 86-128, 1986-51 I.R.B. 22; P.L.R. 96-25-038 (Mar. 25, 1996); P.L.R. 2000-40-019 (July 6, 2000).

An S corporation’s "net recognized built-in gain" for any taxable year is the least of:

1. Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover [defined below] (pre-limitation amount);
2. Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and
3. The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

I.R.C. § 1374(d)(2); Reg. § 1374-2(a).

Net operating loss and capital loss carryforwards from the S corporation’s C years (or from the C years of a corporation whose assets were acquired by the S corporation in a nontaxable carryover-basis transaction described in section 381(a)) reduce the S corporation's net recognized built-in gains to the extent that their use is not otherwise limited or disallowed under the rules that apply to C corporations (for example, sections 269, 382, 383, and 384). I.R.C. § 1374(b)(2); Reg. §§ 1.1374-1(b), (c), -5. Proposed Regulation section 1.1374-5(a) would also allow a loss that is attributable to the basis of redeemed stock under Regulation section 1.302-5 as a deduction against net recognized built-in gain, but only to the extent that the loss arose in a year in which the S corporation was a C corporation. Any
begins on the effective date of a C corporation’s S election (or on the date of an S corporation’s acquisition of a C corporation’s assets in a nontaxable carryover-basis transaction). Gains recognized and taxed under section 1374 other loss carryforwards, such as charitable contribution carryforwards under section 170(d)(2), are not allowed as deductions in computing the corporation’s net recognized built-in gain. Reg. § 1.1374-5(a).

Although these loss carryforwards are permitted to offset recognized built-in gains, they do not reduce the amount of income or gain that passes through to the S corporation’s shareholders. I.R.C. § 1374(b)(2) (net operating loss carryforwards can be used as a deduction only “for purposes of this section”).

An S corporation is also allowed to reduce its tentative tax liability under section 1374 by any business credit carryforwards under section 39, and any alternative minimum tax credit carryforwards under section 53, subject to the limitations otherwise applicable under sections 269, 382, 383, and 384. I.R.C. § 1374(b)(3)(B); Reg. §§ 1.1374-1(b), (c), -6. Any other credits or credit carryforwards, such as foreign tax credits under section 901, are not allowed as credits against the section 1374 tax. Reg. § 1.1374-6(a).

Neither the statute nor the regulations authorize the carryback of net operating losses, capital losses, or business credits from subsequent C years to prior S years in computing the corporation’s net recognized built-in gain or its section 1374 tax liability.

If an S corporation's net recognized built-in gain (its pre-limitation amount under No. 1, above) for any tax year is greater than its taxable income limitation (limitation No. 2, above), the excess of its pre-limitation amount over its taxable income limitation is a “recognized built-in gain carryover” that must be included in its pre-limitation amount for the succeeding tax year. This carryover rule is not symmetrical: net recognized built-in losses do not carry over to the succeeding tax year. Consequently, wherever possible, dispositions of built-in loss assets should be timed so that the built-in losses are recognized in the same year that built-in gains of an equal or greater amount are also recognized.

The maximum amount of net recognized built-in gains that can be taxed under section 1374 during is generally limited to the corporation’s “net unrealized built-in gain” (limitation No. 3, above). I.R.C. § 1374(c)(2). Generally stated, this is the net amount of gain that would have been recognized by the corporation if, at the beginning of the first day of the ten-year recognition period, it had remained a C corporation and had sold all of its assets at their fair market value to an unrelated party. I.R.C. § 1374(d)(1); Reg. § 1.1374-3(a).

The ten-year recognition period is a period of 120 months and it is determined without regard to the number of tax years that fall within that period. Reg. § 1.1374-1(d). If the ten-year recognition period ends during, rather than at the end of, an S corporation's tax year (where, for example, one or more of the corporation’s tax years during this period was a short tax year), the S corporation must determine its pre-limitation amount for that
flow through to the S corporation’s shareholders net of the tax imposed on the corporation.\textsuperscript{17}

The enactment of section 1363(d) in 1987 was in response to the belated realization that the ten-year reach of section 1374 was generally inadequate in preventing the permanent avoidance of corporate-level taxes on the “LIFO reserves”\textsuperscript{18} built into a C corporation’s LIFO inventories.\textsuperscript{19} This is because once income has been initially deferred under LIFO, that deferral will continue for as long as (1) the layer or layers in which all or some portion of the LIFO reserve is embedded remains in ending inventory and (2) the current unit cost of the inventory item is

\textsuperscript{17}I.R.C. § 1366(f)(2); Reg. § 1.1366-4(b). The corporate-level tax imposed under section 1374 is treated as a “loss” sustained by the S corporation for the taxable year in which the built-in gain is recognized and the tax is imposed, regardless of the year in which the tax is actually paid. This loss is assigned the same character as the gain or income on which the tax was imposed. The tax is therefore deductible by the S corporation’s shareholders as an ordinary loss, a capital loss, or a section 1231 loss, as the case may be.

\textsuperscript{18}See supra note 8 (“LIFO reserve” defined).

\textsuperscript{19}Shortly after the enactment of section 1374 by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, the Service announced that it would issue regulations that would provide that “the inventory method used by the taxpayer for tax purposes . . . shall be used to identify whether goods disposed of following conversion to S corporation status were held by the corporation at the time of conversion.” Announcement 86-128, 1986-51 I.R.B. 22. Consequently, a LIFO method C corporation’s LIFO reserves would not have been subject to section 1374 “except to the extent that a LIFO layer existing
greater than or equal to the cost of that item at the time the LIFO reserve was created or increased. For most LIFO-method taxpayers, the combined effect of rising inventory acquisition costs and stable or increasing ending inventory quantities is to defer, more or less indefinitely, the taxable recognition of these built-in gains.

To remedy its initial oversight and to "eliminate [the] potential disparity" between the ultimate corporate-level tax burden of LIFO-method C corporations vis-à-vis FIFO-method C corporations, Congress enacted section 1363(d).

prior to the beginning of [its] first taxable year as an S corporation [was] invaded after the beginning of that year.” Id.

20 See infra Part II (“LIFO IN A NUTSHELL”).

21 FIFO-method converting corporations will almost invariably dispose of their inventory within the ten-year recognition period and recognize the gain built into that inventory as of the date of the conversion-date under section 1374.

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 (first-in, first-out) 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.


See also JOINT COMM. ON TAXATION, 100TH CONG., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES, S.J.C. No. 17-87, 189-90 (Comm. Print 1987):

(1) The provision that imposes a separate corporate-level tax on built-in gains, may be ineffective in the case of a LIFO inventory, since a taxpayer experiencing constant growth may never be required to invade LIFO inventory layers. The LIFO-method C corporation thus may, by converting to S status, escape the recapture tax that would have been imposed had there been a liquidation.
B. Purpose of Article

Unfortunately, section 1363(d) suffers from a number of congenital defects. First, as a threshold matter, it is highly questionable whether section 1363(d), as presently constituted, is the most equitable or efficient approach to achieving the legislative intent that inspired its enactment. Where it applies, section 1363(d) forces LIFO-method converting corporations to recognize, immediately and in a single tax year, unrealized income that has accumulated over several years, perhaps decades, and that, but for section 1363(d), might have otherwise been deferred for many years or decades into the future. The acceleration and bunching of income mandated by section 1363(d) can dramatically increase the present value of the economic burden of the tax liability on the corporation’s LIFO recapture amount, which, in turn, can discourage C corporations with substantial LIFO reserves from availing themselves of the benefits of Subchapter S, or quell otherwise

(2) Under present law, LIFO taxpayers electing S corporation status pay less corporate level tax than FIFO taxpayers since LIFO recapture tax that is not paid within the ten-year period is never recovered.

(3) The provision dealing with conversion from C to S status should conform more closely to the results that would have occurred in a liquidation.
deserving corporate acquisitions where the prospective target of an S corporation is a C corporation with substantial LIFO reserves. And since the income recognized under section 1363(d) does not derive from actual sales or exchanges of the corporation’s LIFO inventory, the cash burden of the resulting taxes can give rise to a potentially severe wherewithal-to-pay problem.\(^ {22} \)

Second, as most recently illustrated by the Eleventh Circuit’s reversal of the Tax Court’s decision in *Coggin Automotive Corp.*,\(^ {23} \) the statutory language of section 1363(d) inexplicably fails to anticipate three scenarios under which LIFO recapture might be avoided with relative ease.\(^ {24} \) Regulations

\[\text{\footnotesize \textsuperscript{22}For these and other reasons, the author believes that section 1363(d) should be repealed. See infra Part VIII ("CONCLUSION").}\]

\[\text{\footnotesize \textsuperscript{23}Coggin Auto. Corp. v. Commissioner, 292 F.3d 1326 (11th Cir. 2002), rev’g 115 T.C. 349 (2000).}\]

\[\text{\footnotesize \textsuperscript{24}Although there are at least four scenarios under which a converting C corporation might otherwise permanently avoid corporate-level taxes on its LIFO reserves, the language of section 1363(d)(1) anticipates only one — the making of an S election by a C corporation that maintained one or more LIFO inventories for the taxable year immediately preceding its first taxable year as an S corporation. Section 1363(d) does not expressly require LIFO recapture:}\]

\[\begin{align*}
(1) & \text{ Where a C corporation disposes of its LIFO inventory to an S corporation in a nontaxable carryover-basis transaction,} \\
(2) & \text{ Where, in anticipation of making an S election (or in anticipation of transferring its assets to an S corporation in a nontaxable carryover-basis transaction), a C corporation (or one or more of its subsidiaries) disposes of its LIFO inventory by transferring that inventory to a partnership in exchange for a partnership interest under section 721, or} \\
(3) & \text{ Where a C corporation already owns an interest in an existing partnership that holds LIFO inventory as of the effective date of the corporation’s S election (or as of the date of the transfer of the}\end{align*}\]
finalized in 1994 address one of them by extending the scope of the application of section 1363(d) to C corporations that transfer LIFO inventory to a new or pre-existing S corporation in an otherwise nontaxable carryover-basis transaction.\textsuperscript{25}

Recently finalized regulations address the other two by overturning the decision of the Eleventh Circuit in \textit{Coggin Automotive} to require LIFO recapture where the LIFO inventory is held indirectly by a converting corporation through one or more partnerships or limited liability companies.\textsuperscript{26}

Finally, the statute is silent or ambiguous as to the proper resolution of several significant technical issues that arise from the application of section 1363(d).

This Article examines the scope and application of section 1363(d) in considerable detail. It critically evaluates the administrative and judicial authorities, including the recently finalized anti-\textit{Coggin Automotive} regulations, that address the partnership interest to an S corporation in a nontaxable carryover-basis transaction).

These three loopholes are readily apparent to the naked eye and it is surprising that the drafters of section 1363(d) did not address them (or expressly authorize the Treasury to address them by regulation). In the context of section 1374, Congress and the Service had been quick to spot and plug the first of these loopholes. See Announcement 86-128, 1986-51 I.R.B. 22; I.R.C. \textsection{} 1374(d)(8) (added in 1988). Regulation section 1.1374-10(b)(1), proposed in 1992 and finalized in 1994, plugged the second of these loopholes retroactively back to the effective date of section 1374, and Regulation section 1.1374-4(i), also proposed in 1992 and finalized in 1994, plugged the third one prospectively for taxable years ending on or after December 27, 1994. Reg. \textsection{} 1.1374-10(a), (b).

\textsuperscript{25}Reg. \textsection{} 1.1363-2(a)(2).
various issues arising from its application. It identifies ambiguities and vagueness that exist under the current regime and suggests the means by which they might be eliminated or ameliorated. The Article concludes with the assertion that the anti-avoidance approach adopted by Congress in enacting section 1363(d) is unduly harsh and that it is incongruent with the legislative intent that originally inspired and presently sustains the special tax treatment accorded S corporations.

This Article is divided into seven parts. Part II presents a brief description of the LIFO method of accounting for inventories. Part III identifies the events that trigger the application of section 1363(d) under the statute and under the regulations. Part IV addresses the computation of the LIFO recapture amount and the incremental amount of net income that is subject to the tax. Part V discusses how the tax is calculated and paid. Part VI describes the basis adjustments that are required and permitted under the statute and the regulations. Part VII deals with the effect that the recognition of income under section 1363(d) will have on the converting corporation’s earnings and profits and the effect that the incremental tax incurred and paid on that income will have on

\[26\text{Reg. } § 1.1363-2(b).\]
its earnings and profits, on its accumulated adjustment account, and on its shareholders’ stock basis.

In Part VIII, the author argues that section 1363(d) is premised on faulty reasoning, that it unduly compromises the pro-small-business policy manifest in Subchapter S, and that, for these and other reasons, it should be repealed forthwith. He advocates an alternative anti-avoidance regime that would ameliorate the distortion, confusion, and redundant complexity created by the current rules, and that would be more congruent with the objectives that section 1363(d), the provisions authorizing the adoption and use of the LIFO method of accounting for inventories, and the provisions of Subchapter S generally, were respectively enacted to achieve.

II. LIFO IN A NUTSHELL

One of the principal objectives of inventory accounting is to match the cost of the goods sold during a specified period with the revenues generated from the sale of those goods in order to determine a taxpayer’s income for that period. Once sales revenues for the period have been determined, the total
cost of all of the goods available for sale during the period\textsuperscript{27} must be allocated between (1) the “cost of goods sold” during that period (which is deducted currently in computing the taxpayer’s “gross income” for the period\textsuperscript{28}), and (2) the goods that remain on hand in the taxpayer’s “ending inventory” (and which will be deducted in a future period when these goods are sold or otherwise disposed of in a taxable transaction). The accomplishment of this essential function requires either (1) the specific identification of the cost associated with each unit of inventory available for sale during the period,\textsuperscript{29} or (2) an assumption as to the manner in which inventory costs flow\textsuperscript{30} from the Inventory account into the Cost of Goods Sold account.\textsuperscript{31}

\textsuperscript{27}The cost of goods available for sale is the sum of (1) the cost of inventory on hand at the beginning of the period, and (2) the cost of inventory purchased or manufactured during the period.

\textsuperscript{28}Reg. § 1.61-3(a).

\textsuperscript{29}Conceptually, the specific identification of the respective costs of the goods sold and unsold would seem optimal. As the name suggests, a cost is specifically identified with each inventory item and that cost is separately tracked through the inventory accounting system. However, except in the special case of low-volume, high-unit-value retailers (for example, a jewelry store), the burden imposed by the recordkeeping required to account for inventories of fungible and intermingled goods under this method generally renders its use impossible, prohibitively expensive, or simply impractical.

\textsuperscript{30}Cost-flow assumptions are required for two reasons. First, a going concern typically holds inventories of merchandise, raw materials, etc. at the end of one period in anticipation of sales or manufacturing activities that will take place in the following period. If the taxpayer had no ending inventory (or if taxpayers were permitted to simply expense their inventory costs in the period in which the inventory was purchased or manufactured), then all of the costs incurred in acquiring or manufacturing merchandise for sale to customers in the ordinary course of conducting the taxpayer’s business would simply be transferred to cost of goods sold and deducted in the current period - no allocation would be required.

Second, the costs of acquiring or manufacturing inventory change constantly. If these costs did not change, the issue of which of these
differential amounts should be allocated to the units sold during the period and which should be allocated to the units that remain in ending inventory would be moot.

31Not all manufacturers, producers, and resellers are required to account for their inventories under section 471. An election is available for certain taxpayers to instead treat their inventories of raw materials, work-in-process, finished goods, and purchased goods as nonincidental “materials and supplies,” which are deductible as expenses in the year they are used, consumed, or sold. See Reg. § 1.162-3. These administrative rules were designed to “reduce the administrative and tax compliance burdens of certain small business taxpayers,” to “simplify the record keeping requirements” imposed on them, and to “minimize disputes between the . . . Service and [eligible] small business taxpayers.” Rev. Proc. 2002-28, 2002-1 C.B. 815.

Subject to several exceptions and refinements, a taxpayer may generally elect to be exempted from inventory accounting, and from the required use of the accrual method of accounting, if-

(1) The taxpayer’s average annual gross receipts have never exceeded $1 million for any three-taxable-year period ending with any prior taxable year that closed after December 17, 1998, or

(2) The taxpayer’s average annual gross receipts have never exceeded $10 million for any three-taxable-year period ending with any prior taxable year that closed after December 31, 2000, and the taxpayer is a “qualifying small business taxpayer” (i.e., a taxpayer that is not prohibited by section 448 from using the cash method). A taxpayer qualifying under this latter exemption must nevertheless use inventory accounting (and the accrual method) with respect to any trade or business wherein the principal business activity is mining (within the meaning of NAICS Codes 211 and 212), manufacturing (within the meaning of NAICS Codes 31 – 33), wholesale trade (within the meaning of NAICS Code 42), retail trade (within the meaning of NAICS Codes 44 and 45), or information industries (within the meaning of NAICS Codes 5111 and 5122).


Section 448 prohibits the use of the cash method of accounting by a “tax shelter.” I.R.C. §448(a)(3), (d)(3). It also denies the use of the cash method to C corporations and to partnerships having one or more C corporation partners, unless (1) the corporation’s or partnership’s trade or business is farming, (2) the corporation (or the corporate partner or partners of a partnership) is a “qualified personal service corporation” within the meaning of section 448(d)(2), or (3) the C corporation’s or the partnership’s average annual gross receipts have never exceeded $5 million for any three-taxable-year period ending with any prior taxable year that closed after December 31, 1985.

Revenue Procedures 2001-10 and 2002-28 each provide automatic procedures for qualifying taxpayers who elect to change from their current method to a method described in the applicable revenue procedure. A change to or from such method is a change in a method of accounting to which section 481 applies. See infra note 57 (overview of section 481). The requirements of these revenue procedures must be satisfied at the time of the election and for each taxable year thereafter. If and when an electing taxpayer ceases to qualify, it must change to the accrual method of accounting for its income and its inventories. See Dennis J. Gaffney et al., The Cash-Method Odyssey...
The two alternative cost-flow assumptions that are generally available to achieve this allocation are the “first-in, first-out” (FIFO) assumption and the “last-in, first-out” (LIFO) assumption. Significantly, neither the tax law\(^{32}\) nor generally accepted accounting principles\(^{33}\) require that there be any correlation whatsoever between the assumed flow of costs adopted for accounting purposes and the actual physical flow of the goods themselves.\(^{34}\) Furthermore, although the choice of one cost-flow assumption over the other usually has a pronounced effect upon the timing of the gross profits recognized by the taxpayer, the total nominal (i.e., undiscounted) amount of the gross profit that will ultimately be recognized from the sale of the inventory over the life of the firm will generally be the same under both methods.\(^{35}\)

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\(^{32}\)Reg. § 1.472-1(a) (“The LIFO inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand . . . .”).

\(^{33}\)See, e.g., ACCOUNTING RESEARCH BULLETIN No. 43, Ch. 4, para. 6.

\(^{34}\)As a practical matter, the physical movement of the merchandise of the vast majority of manufacturers, wholesalers, and retailers conforms much more closely to FIFO than it does to LIFO. In order to minimize losses associated with deterioration, obsolescence, changing consumer preferences, and like factors, taxpayers typically manage their inventories such that the oldest merchandise (the first in) is the first to be sold (the first out).

\(^{35}\)Permanent differences do result, of course, when the “time value of money” is taken into account (i.e., when the future recognition of currently deferred income is discounted to determine its present value equivalent). When time value of money is taken into account, the deferral of tax liability
Figures 1a through 1d supplement the following discussion of these two methods by illustrating (1) the mechanics of applying the FIFO and LIFO cost-flow assumptions, (2) the impact that each of these methods respectively has on Cost of Goods Sold, ending Inventory, and gross income, (3) the manner in which the LIFO reserve is calculated, and (4) tax savings that result from the use of LIFO during periods of rising costs.

that usually results from the adoption and implementation of LIFO gives rise to permanent tax savings.

Permanent differences in tax liability can also result from the incidental application of anomalies in the tax law that are otherwise unrelated to inventory accounting and taxation. Examples include: (1) changes in the applicable tax rates that occur between the year of the initial deferral and the subsequent year in which that deferral is ultimately recognized and taxed, and (2) the transformation of a temporary deferral of gross profit under LIFO into a genuinely permanent deferral where the basis of the inventory of a sole proprietorship (or of a partnership or limited liability company under sections 754 and 743(b)) is stepped-up under section 1014 upon the death of the sole proprietor (or partner or member, as the case may be).

Finally, permanent differences can result from the creation of “phantom” gains where (1) LIFO inventory is transferred to a C corporation by a non-C corporation transferor in an exchange qualifying under section 351(a) (the concomitant basis adjustments respectively required under section 358(a)(1) and section 362(a) have the effect of cloning the gain built into the inventory at the time of the exchange), and where (2) a LIFO-method S corporation loses or revokes its S election or transfers its assets to a C corporation in a nontaxable reorganization. See infra Part IV.D.2. (“Pre-Immersion Accruals of the LRA”).

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The salient facts presented in this example are set forth in Figure 1a. Assume that the taxpayer acquired its initial inventory late in 2000 and began selling this inventory in 2001. Both the taxpayer’s acquisition cost and the retail sales price of this inventory increased in each year from 2000 to 2005. Physical quantities of ending inventory increased in 2001, 2002, and 2004, and decreased in 2003 and 2005 (when this inventory item was discontinued).

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Units in Beginning Inventory</th>
<th>Purchases</th>
<th>Units Available for Sale</th>
<th>Sales</th>
<th>Units Remaining in Ending Inventory</th>
<th>Unit Increase or Decrease</th>
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<td>Units Sold</td>
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<td>Total: 70,350</td>
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A. FIFO Cost-flow Assumption
Under the FIFO cost-flow assumption, the costs of the goods available for sale are allocated between Cost of Goods Sold and ending Inventory in the chronological order in which these costs were incurred — the first inventory units acquired are deemed to be the first units sold. Consequently, the least-recent inventory acquisition costs are the costs that are first allocated to Cost of Goods Sold, and ending Inventory is composed of the costs that were incurred to acquire the most recently acquired units.36

Figure 1b illustrates the application of the FIFO assumption. Note that all of the goods that were in beginning inventory are deemed to have been sold during the current year and their costs have been transferred out of the Inventory account and into the Cost of Goods Sold account. Consequently, only the costs incurred with respect to current-year inventory acquisitions remain in ending Inventory.

36The regulations establish the FIFO assumption as the default assumption — unless a LIFO election is made, the FIFO assumption is generally required. Reg. § 1.471-2(d). FIFO is also the cost-flow assumption that is required to be used by a C corporation for the purposes of computing (1) its “earnings and profits,” and (2) its “adjusted current earnings” under the alternative minimum tax system. I.R.C. §§ 312(n)(4), 56(g)(4)(D)(iii).

A taxpayer using the LIFO cost-flow assumption for regular income tax purposes can generally transform its LIFO earnings into FIFO earnings through the relatively simple device of adjusting the former amount by the change in the LIFO reserve that has taken place during the current period.
<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Units Available for Sale</th>
<th>Goods Sold</th>
<th>Ending Inventory</th>
<th>Sales Revenue</th>
<th>Cost of Goods Sold</th>
<th>Gross Profit</th>
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</tbody>
</table>

Figure 1b
FIFO Cost Flow Assumption

The use of the FIFO method during a period of rising inventory costs matches the oldest, lower-cost inventory with current sales revenues and results in taxable income that is generally higher than it would be under LIFO. The converse is also true: during a period of declining inventory costs, FIFO typically produces taxable income that is lower than it would have been under LIFO since, under FIFO, the older, higher-cost inventory is matched against current sales revenues. Note that taxpayers who adopt LIFO are not generally required to use LIFO for all of their inventories.37 Instead, many LIFO-method

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37Reg. §§ 1.472-1, -3. Note, however, that where the Service determines that a clear reflection of income requires the use of the LIFO method to value inventory other than the inventory specified in the taxpayer’s LIFO application, it may require the taxpayer to apply the LIFO method to such
taxpayers adopt LIFO for inventories that are expected to experience rising replacement costs, and FIFO for inventories that are expected to experience declining replacement costs.

B. LIFO Cost-flow Assumption

Since the late 1930’s, the federal income tax statutes have expressly authorized the adoption and use of the LIFO method in computing taxable income.\textsuperscript{38} Taxpayers that elect the LIFO method

\textsuperscript{38}The use of LIFO in computing taxable income is authorized under section 472. An election to use the LIFO method must be made with the tax return for the tax year for which that method is first adopted. The election is made on Form 970 or in any other manner that may be acceptable to Service. Reg. § 1.472-3(a). An election other than on Form 970 is acceptable, but only if the taxpayer includes all of the information required on, or to be filed with, Form 970 on his timely-filed return for the tax year for which LIFO is first adopted. Rev. Proc. 74-2, 1974-1 C.B. 412. Merely indicating on the return that the LIFO method has been adopted is not, however, sufficient. Rev. Rul. 78-262, 1978-2 C.B. 170; Martin's Inc. of Moberly v. Commissioner, 54 T.C.M (CCH) 247, 1987 T.C.M. (RIA) ¶ 87,419 aff'd without published opinion, 855 F.2d 857 (8th Cir. 1988).

Until the middle-to-late 1930s, LIFO was not a widely used or generally accepted method of accounting for inventories and cost of goods sold. (According to testimony submitted to the Senate Finance Committee, only a handful of companies appeared to have used LIFO (or similar methods) in their corporate accounts prior to the mid-1930s. See Senate Finance Committee, Hearings before the Committee on Finance on H.R. 9682, 75th Congress, 3rd Session, at 143 to 167. Few, if any, accounting textbooks even mentioned the LIFO method. See, e.g., H. R. Hatfield, ACCOUNTING: ITS PRINCIPLES AND PROBLEMS (1927); H. A. Finney, PRINCIPLES OF ACCOUNTING: INTERMEDIATE (1934). Nor was its use permitted for income tax purposes. Prior to 1939, taxpayers were required to
to account for one or more of their inventories for tax purposes must also use the LIFO method for financial reporting purposes.\textsuperscript{39}

use either the specific identification method or the FIFO method of inventory valuation.

Effective for taxable years that began after December 31, 1938, producers and processors of certain nonferrous metals generally were permitted to elect the LIFO inventory method for unprocessed raw materials, and tanners generally were allowed to elect the LIFO method for "raw materials (including those included in goods in process and in finished goods)." Revenue Act of 1938, ch. 289, 52 Stat. 447, § 22(d)(1)-(3). Effective for taxable years that began after December 31, 1938, Congress expanded the right to utilize the LIFO method of accounting to virtually all taxpayers. Revenue Act of 1939, 53 Stat. 862, § 22(d).


\textsuperscript{39}I.R.C. § 472(c), (e)(2). The legislative history provides no explanation for the conformity requirement. It appears, however, to have been enacted for two reasons. The first was to limit use of LIFO for tax purposes to industries where the accounting profession viewed it as an acceptable method. Rev. Rul. 74-586, 1974-2 C.B. 156 ("... the purpose of the requirement was to give assurance that with respect to a particular taxpayer the LIFO method clearly reflects income."). The second appears to have been to limit the erosion of tax revenues by discouraging the use of the LIFO method. Richard B. Barker, \textit{Practical Aspects of Inventory Problems Under Current Conditions: LIFO, Involuntary Liquidations}, 10TH NYU ANNUAL INSTITUTE ON FEDERAL TAXATION 511-12 (1952).

Prior to 1981, the Treasury Department’s strict interpretation of the conformity requirement had the practical effect of requiring that the tax rules governing the determination of ending inventory and cost of goods under the LIFO method be accepted and applied for financial reporting purposes under GAAP. In 1981, the Treasury Department issued regulations that considerably relaxed its interpretation of the LIFO conformity requirement (and did so retroactively back to 1954). T.D. 7756, 1981-1 C.B. 316. These regulations permitted (and continue to permit) (1) certain supplemental disclosures, including pro forma financial statements, of non-LIFO information in the financial statements of firms that have adopted LIFO for tax purposes, and (2) the use of procedures and principles that result in differences in the way that the amounts reported under LIFO for financial reporting purposes and for tax purposes are determined. Reg. § 1.472-2(e).

For a discussion of the financial accounting principles governing the use of LIFO, see American Inst. of Certified Public Accountants, Task Force on LIFO Inventory Problems, \textit{ISSUES PAPER, IDENTIFICATION AND DISCUSSION OF CERTAIN FINANCIAL ACCOUNTING AND REPORTING ISSUES CONCERNING LIFO INVENTORIES}, (November 30, 1984).
Although there are literally dozens of permutations and variations of the LIFO method, the two basic approaches to LIFO are the specific-goods LIFO method and dollar-value LIFO method, both of which are discussed and illustrated below.

1. Specific-goods LIFO

As the name implies, the LIFO cost-flow assumption is the inverse of the FIFO assumption. Under LIFO, the costs of the goods available for sale are allocated between Cost of Goods Sold and ending Inventory in the reverse of the chronological order in which these costs were incurred: the last inventory units acquired are deemed to be the first units sold. Consequently, the most-recent inventory acquisition costs are the costs that are first costs allocated to Cost of Goods Sold. Ending Inventory is therefore composed of the costs that were incurred to acquire the units that were least-recently acquired. Figure 1c illustrates the application of the LIFO assumption.
From an accounting perspective, the typical LIFO ending inventory is conceptualized as an aggregation of several heterogeneous “layers” of units and unit costs. A new layer, or “increment,” is formed in any year in which ending inventory quantities exceed beginning inventory quantities. These incremental units (and their costs) are preserved as a discrete component of the beginning inventory of the succeeding year. Accordingly, although the units in ending inventory are physically indistinguishable from one another, LIFO accounting
creates artificial distinctions between units that were acquired in different years and for different amounts.

The oldest, and therefore most impenetrable, layer in ending inventory is the base-year layer. This layer is initially composed of all of the units of inventory that were on hand at the beginning of the first year for which a LIFO election was in effect. The cost that attaches to each of the units in this base-year layer is the taxpayer’s average cost of all of them.40

Additional annual LIFO layers are created only in years in which an increment occurs. A LIFO increment is the excess of the number of units on hand as of the end of the year over the number of units on hand as of the beginning of that year.41 The cost of the units in an increment is their current cost.42 In the years in

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40 Reg. § 1.472-2(c). Additionally, if the cost of these units had previously been written downs to market under the taxpayer’s previous inventory method (using the lower-of-cost-or-market method), the carrying cost of these units must be restored to their actual cost by recapturing the previous write-down as income. See infra note 130 (overview of lower-of-cost-or-market method).

41 In Figure 1a the taxpayer experienced increments in 2001, 2002, and 2004 of 100 units, 300 units, and 250 units, respectively.

42 Since inventory is typically acquired at several different times and for several different amounts throughout the year, a determination must also be made as to which of these costs are to be used in costing a current increment. The three most common methods are:

(1) The “most-recent-acquisition” method, under which the actual costs of the goods most recently acquired are the costs that are associated with the units that make up the current increment;

(2) The “earliest-acquisition” method, under which the actual costs of the goods that were first purchased during the year are the costs that are associated with the units that make up the current increment; and
which an increment occurs, ending inventory can be determined by simply adding the cost of the units in the increment to the total cost of beginning inventory.

As illustrated in Figure 1c, basic LIFO accounting requires that the taxpayer’s records preserve (1) the chronological sequence of all of the layers remaining in its ending inventory, (2) the quantity of units in each of these layers, and (3) their respective costs. In years in which the number of units in ending inventory falls below the number in beginning inventory (i.e., the number of units sold exceed the number of units purchased during the period), a LIFO decrement occurs and these LIFO inventory records must be consulted to establish the layers from which the decremented units were sold. Under LIFO, these units are deemed to come from the layers that made up beginning inventory in reverse chronological order: the most recently

| 43See also Reg. § 1.472-2(h) (imposing mandatory recordkeeping requirements). Several commentators have opined as to the general scope and detail of the LIFO recordkeeping requirements. See, e.g., Stephen F. Gertzman, FEDERAL TAX ACCOUNTING, 7-28, 7-29 (1993); Leslie J. Schneider, FEDERAL INCOME TAXATION OF INVENTORIES, § 10.02(d) (1979); William R. Sutherland, INVENTORIES: METHODS, VALUATION, AND UNIFORM CAPITALIZATION RULES, 142 (1995).}
acquired units, together with their respective costs, are removed from the Inventory account and transferred to the Cost of Goods Sold account. In Figure 1c, the taxpayer experienced a decrement of 350 units in 2003 (300 units from the 2002 increment and then 50 units from the 2001 increment), and a complete liquidation of this inventory in 2005.44

Conceptually, the objective of the LIFO method is to afford “relief against profits that merely reflect the bloating of inventory values due to inflation”45 by charging Cost of Goods Sold with the costs of goods most recently acquired. Subtracting current costs from current revenues arguably results in a better matching of revenues and the costs incurred to generate those revenues.46 Pragmatically, however, the principal attraction of LIFO is the extended deferral of taxable income that results from its use during periods of rising inventory acquisition costs and stable or growing inventory quantities. Under LIFO, a deferral of income occurs in any year in which there is an increase in the

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44The elimination of (or reduction in) a layer that results from a decrement is permanent - subsequent increments will create layers for those subsequent years in which they occur, but these increments will not restore all or any part of a previously decremented layer. Figure 1c (2004) illustrates this feature of the LIFO method.

45Kohler Co. v. United States, 124 F.3d 1451, 1457 (Fed. Cir. 1997).

46Most countries around the world, however, do not permit the use of the LIFO method in determining taxable income or book income. See, e.g., INT’L FINANCIAL REPORTING STANDARDS NO. 2 (Int’l Accounting Standards Bd. 2005).
LIFO reserve.\textsuperscript{47}

As previously noted, the LIFO reserve is the cumulative excess of the amount of income that would have been recognized under the FIFO assumption over the amount of income actually recognized under the LIFO assumption. As shown in Figure 1d, the LIFO reserve is calculated by subtracting the LIFO cost of ending inventory from the FIFO value of that ending inventory. The LIFO reserve will always increase in years during which inventory costs increase and a decrement does not occur.\textsuperscript{48}

\textsuperscript{47}Conversely, income previously deferred under LIFO will generally be recognized in any year in which all or a part of an existing LIFO reserve is liquidated. But see section 473 ("Qualified liquidations of LIFO inventories"), which allows a taxpayer to elect to perpetuate the deferral of some or all of the income built into liquidated LIFO layers where (1) the liquidation is directly and primarily attributed to a "qualified inventory interruption" (for example, an embargo, international boycott, or other major foreign trade interruption, or a regulation or request of the Department of Energy relating to energy supplies), and (2) the taxpayer restores its inventory quantities within the succeeding three years (or a shorter period based on the Service’s evaluation of the cause of the inventory interruption).

\textsuperscript{48}An increase in the LIFO reserve can also occur in a year in which there has been a decrement if (1) inventory acquisition costs have increased during that year, and (2) the increase in the LIFO reserve associated with the units that remain in ending inventory (due to the increase in acquisition costs occurring in that year) is greater than the LIFO reserve associated with the decremented units as of the beginning of that year.
Once income has been initially deferred under LIFO, that deferral will continue for as long as (1) the layer or layers in which all or some portion of the LIFO reserve is embedded remain in ending Inventory,\(^\text{49}\) and (2) the current unit cost of the inventory item is greater than or equal to the cost of that item.
at the time of the LIFO reserve was created or increased. For LIFO-method taxpayers who experience extended periods of uninterrupted growth, the combined effect of rising unit costs and increasing inventory quantities is to defer the taxable recognition of substantial amounts of income for years, typically decades, into the future.50

2. Dollar-value LIFO

For LIFO-method taxpayers, the most critical determination that must be made each year is whether and to what extent inventory quantities have increased or decreased during that year. If inventory quantities have increased, Cost Of Goods Sold will be comprised of only the current (generally higher) inventory acquisition costs. But if inventory quantities have decreased during the year, then the transfer to Cost Of Goods Sold of the older (generally lower) costs that were previously embedded in the decremented LIFO layer or layers of the taxpayer’s beginning Inventory will accelerate the taxable

50When the time value of money is thrown into the equation, the effect of these extended deferrals is to significantly reduce the economic burden of the ultimate tax liability. For example, at a discount rate of five percent (ten percent), the present value of a $1 tax liability that is deferred ten years is only $0.61 ($0.39). A deferral of 25 years or 50 years reduces this burden even further to $0.30 ($0.09) and $0.09 ($0.01), respectively.
recognition of income that would otherwise have continued to be deferred.

There are two alternative approaches to measuring quantity changes: the specific-goods approach (which was described and illustrated above) and the dollar-value approach. As the name suggests, the specific-goods approach requires that each item (or grouping of very similar items) be independently accounted for as a separate inventory. This is because inventory quantities — and changes in these quantities — are measured in terms of physical units (i.e., tons, barrels, bales, cans, boxes, etc.) and because the addition of the physical quantity measures of dissimilar goods produces a meaningless sum (for example, 200 electric drills + 150 vacuum cleaners + 25 cans of peaches = 375 units).

Strict application of the specific-goods LIFO method thus presents several practical difficulties that would generally preclude the adoption of LIFO by taxpayers with large, diversified inventories. First, as is readily apparent from a quick glance at Figure 1c vis-à-vis Figure 1b, specific-goods LIFO requires a considerable amount of detailed and cumbersome bookkeeping. As with other methods, the physical quantities of each distinct item in inventory must be determined from either a physical count or from the taxpayer’s perpetual inventory
records. But under LIFO, unit costs must then be applied in the sequence that defines the LIFO assumption for all of the years following the adoption of LIFO. Consequently, the accounting records must preserve the year, the costs, and the quantities that define each of the LIFO layers and must do so for each of the taxpayer’s inventories. Under specific-goods LIFO, a large retailer would, for example, be required to separately track its inventories for each of perhaps thousands of different items of merchandise.

Second, under specific-goods LIFO, transitory fluctuations in the relative physical quantities of similar inventory items can result in partial or complete liquidations of old, low-cost LIFO layers (and the consequential loss of part or all of the accumulated tax benefits of the LIFO method) even though overall inventory quantities have increased. For example, the quantity of one inventory item (e.g., BrandX electric drills) may decline during the same period that the quantity of other similar items (e.g., BrandZ electric drills and electric circular saws) has increased. Since specific-goods LIFO requires that these similar, but nevertheless unique, items be independently accounted for, the quantity increase in the latter items will not offset the quantity decrease of the former. Consequently,
the low costs embedded in the old LIFO layers of the first item will be allocated to Cost Of Goods Sold.

Finally, a more draconian result obtains where changes in technology, style, etc. result in the permanent replacement of older items with newer versions of those items. Under specific-goods LIFO, a new LIFO Inventory account must generally be created for the newer version. As the older version is phased out, the balance in that item’s Inventory account will be permanently reduced to zero as these amounts are transferred to the Cost of Goods Sold account. This process results in the taxable recognition of the accumulated LIFO reserve that built up with respect to the replaced item throughout the period preceding the liquidation. In Figure 1c, the entire accumulated LIFO reserve built into the 500-unit 2005 beginning Inventory ($1,900) was recaptured in 2005 when this inventory item was discontinued.

The dollar-value adaptation of the LIFO method uses price indexes and inventory pools to ameliorate the deficiencies inherent in the specific-goods LIFO method.\textsuperscript{51} The defining

\textsuperscript{51}In Hutzler Bros. Co. v. Commissioner, 8 T.C. 14, 31 (1947), the Tax Court ruled in favor of the taxpayer’s use of the dollar-value LIFO method to account for its retail department store inventories:

The computations involved may be somewhat extensive, but they lack neither adequate clarity nor logic, and they can not be discarded as unduly burdensome in the light of the permissive character of the statutory option. We conclude that adaptation of the [LIFO] theory to inventories maintained in terms of
characteristic of the dollar-value LIFO method is the substitution of base-year dollars for physical units as the accounting measure of the ending inventory quantity and of increments or decrements in that quantity. Stated differently, under dollar-value LIFO, physical quantities are expressed in a unit-of-measure (i.e., base-year dollars) that is common to all types of merchandise inventory, but that is entirely unrelated to the physical characteristics of the inventory items themselves. Consequently, rather than applying all of the LIFO accounting procedures to many separate inventories, each of which would be comprised of identical or near-identical goods, the dollar-value LIFO method makes it possible for a taxpayer to group or “pool” several different types of goods and account for all these goods together as a single inventory. This greatly simplifies accounting for inventories. More importantly, pooling affords significantly greater protection from the consequences that typically result from involuntary LIFO layer liquidations. This is because (1) decreases in the quantity of one item in a pool are offset by increases in the quantity of other items in the same pool, and because (2) newer versions of older items

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dollars through the approach generally employed by the present petitioner is permissible and proper . . . .

In Basse v. Commissioner, 10 T.C. 328 (1948), the Tax Court approved the use of dollar-value LIFO by non-retail-method companies.
that are phased out are accounted for in the same pool, rather than in a new pool.\footnote{See Regulation section 1.472-8(b), (c), and (d) for the rules governing the establishment and composition of dollar-value LIFO inventory.}

Figures 2a through 2c illustrate the basic mechanics of the dollar-value LIFO method. In this example, the taxpayer, a retailer of men’s apparel, purchased its initial inventory of shirts, slacks, and belts late in 2003 for $20 per unit, $30 per unit, and $25 per unit, respectively. It adopted the dollar-value LIFO method and grouped these three items into a single inventory pool.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Item</th>
<th>Physical Units in Beginning Inventory</th>
<th>Physical Quantity</th>
<th>Unit Cost</th>
<th>Total Cost</th>
<th>Physical Units Available for Sale</th>
<th>Units Sold</th>
<th>Units Remaining in Ending Inventory</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003 (Base Year)</td>
<td>Shirts</td>
<td>0</td>
<td>200</td>
<td>$20</td>
<td>$4,000</td>
<td>200</td>
<td>0</td>
<td>200</td>
</tr>
<tr>
<td></td>
<td>Slacks</td>
<td>0</td>
<td>100</td>
<td>$30</td>
<td>$3,000</td>
<td>100</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Belts</td>
<td>0</td>
<td>50</td>
<td>$25</td>
<td>$1,250</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>$8,250</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>Shirts</td>
<td>200</td>
<td>1,000</td>
<td>$21</td>
<td>$21,000</td>
<td>1,200</td>
<td>1,100</td>
<td>100</td>
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<tr>
<td></td>
<td>Slacks</td>
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<td>500</td>
<td>$33</td>
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<td>150</td>
</tr>
<tr>
<td></td>
<td>Belts</td>
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<td>200</td>
<td>$28</td>
<td>$5,600</td>
<td>250</td>
<td>100</td>
<td>150</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>$43,100</strong></td>
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<tr>
<td>2005</td>
<td>Shirts</td>
<td>100</td>
<td>1,250</td>
<td>$22</td>
<td>$27,500</td>
<td>1,350</td>
<td>1,200</td>
<td>150</td>
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<tr>
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<td>Slacks</td>
<td>150</td>
<td>750</td>
<td>$36</td>
<td>$27,000</td>
<td>900</td>
<td>800</td>
<td>100</td>
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<tr>
<td></td>
<td>Belts</td>
<td>150</td>
<td>300</td>
<td>$31</td>
<td>$9,300</td>
<td>450</td>
<td>400</td>
<td>50</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td><strong>$63,800</strong></td>
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<td></td>
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</tr>
<tr>
<td>2006</td>
<td>Shirts</td>
<td>150</td>
<td>1,500</td>
<td>$23</td>
<td>$34,500</td>
<td>1,650</td>
<td>1,400</td>
<td>250</td>
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<tr>
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<td>Slacks</td>
<td>100</td>
<td>500</td>
<td>$39</td>
<td>$19,500</td>
<td>600</td>
<td>450</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>Belts</td>
<td>50</td>
<td>250</td>
<td>$35</td>
<td>$8,750</td>
<td>300</td>
<td>200</td>
<td>100</td>
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<td></td>
<td></td>
<td></td>
<td><strong>$62,750</strong></td>
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<td></td>
</tr>
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</table>

Figure 2a
Summary of Facts
The dollar-value LIFO method employs the same cost-flow assumption as the specific-goods LIFO method. As with specific-goods LIFO, the quantity of units in ending inventory and the manner in which this quantity is dispersed among the various LIFO layers must be determined. But instead of expressing these quantities in terms of physical units, they are measured and expressed in terms of "base-year dollars" (BY$). The base-year-dollar value of the ending inventory of a given pool is derived by multiplying the number of units of each item in that pool by that item’s base-year cost. Since the base-year cost of each unit of each item in a pool is fixed, any change in the total base-year-dollar value of ending inventory from one year to the next is due exclusively to changes in physical quantity. In Figure 2b, the taxpayer experienced an increment of BY$2,000 (BY$10,250 - BY$8,250) in 2004 and of BY$4,750 (BY$12,000 - BY$7,250) in 2006. It experienced a decrement of BY$3,000 (BY$7,250 - BY$10,250) in 2005 (BY$2,000 from the 2004 layer and BY$1,000 from the 2003 base-year layer).
### Figure 2b

**Computation of Indexes (Using the Double-Extension Method)**

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Item</th>
<th>Current Costs Per Unit</th>
<th>Units Remaining in Ending Inventory</th>
<th>Ending Inventory at:</th>
<th>Increment in Base-Year Dollars</th>
<th>LIFO Index [CY$ ÷ BY$]</th>
<th>Actual Cost Basis of Increment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Current Costs</td>
<td>Base-Year Costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003 (Base Year)</td>
<td>Shirts</td>
<td>$20</td>
<td>200</td>
<td>200 units x $20 = CY$ 4,000</td>
<td>200 units x $20 = BY$ 4,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Slacks</td>
<td>$30</td>
<td>100</td>
<td>100 units x $30 = CY$ 3,000</td>
<td>100 units x $30 = BY$ 3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belts</td>
<td>$25</td>
<td>50</td>
<td>50 units x $25 = CY$ 1,250</td>
<td>50 units x $25 = BY$ 1,250</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CY$ 8,250</td>
<td>BY$ 8,250</td>
<td>n/a</td>
<td>1.0000 $ 8,250</td>
</tr>
<tr>
<td>2004</td>
<td>Shirts</td>
<td>$21</td>
<td>100</td>
<td>100 units x $21 = CY$ 2,100</td>
<td>100 units x $20 = BY$ 2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Slacks</td>
<td>$33</td>
<td>150</td>
<td>150 units x $33 = CY$ 4,950</td>
<td>150 units x $30 = BY$ 4,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belts</td>
<td>$28</td>
<td>150</td>
<td>150 units x $28 = CY$ 4,200</td>
<td>150 units x $25 = BY$ 3,750</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CY$ 11,250</td>
<td>BY$ 10,250</td>
<td>BY$ 2,000</td>
<td>1.0976 $ 2,195</td>
</tr>
<tr>
<td>2005</td>
<td>Shirts</td>
<td>$22</td>
<td>150</td>
<td>150 units x $22 = CY$ 3,300</td>
<td>150 units x $20 = BY$ 3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Slacks</td>
<td>$36</td>
<td>100</td>
<td>100 units x $36 = CY$ 3,600</td>
<td>100 units x $30 = BY$ 3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belts</td>
<td>$31</td>
<td>50</td>
<td>50 units x $31 = CY$ 1,550</td>
<td>50 units x $25 = BY$ 1,250</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CY$ 8,450</td>
<td>BY$ 7,250</td>
<td>BY$ 3,000</td>
<td>1.1655 n/a</td>
</tr>
<tr>
<td>2006</td>
<td>Shirts</td>
<td>$23</td>
<td>250</td>
<td>250 units x $23 = CY$ 5,750</td>
<td>250 units x $20 = BY$ 5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Slacks</td>
<td>$39</td>
<td>150</td>
<td>150 units x $39 = CY$ 5,850</td>
<td>150 units x $30 = BY$ 4,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belts</td>
<td>$35</td>
<td>100</td>
<td>100 units x $35 = CY$ 3,500</td>
<td>100 units x $25 = BY$ 2,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>CY$ 15,100</td>
<td>BY$ 12,000</td>
<td>BY$ 4,750</td>
<td>1.2583 $ 5,977</td>
</tr>
</tbody>
</table>
For years in which the taxpayer experiences an increment, it must determine its actual cost of the base-year-dollar units that make up that increment. This is done by multiplying the base-year-dollar value of the increment by an index that reflects the cumulative change in the taxpayer’s actual cost of the items in its ending Inventory for that pool. In Figure 2b, the taxpayer uses the “double-extension” method to develop this index. Under the double-extension method, all of the physical units of each item in the ending inventory of a given pool are multiplied (or “extended”) twice: first by their respective current-year costs (CY$), and then by their respective base-year costs. Ending inventory at current-year cost is then divided by ending inventory at base-year costs to derive the index for the increment. In Figure 2b, the 2004 increment of BY$2,000 had an actual cost basis of $2,195 (BY$2,000 x 1.0976), while the 2006 increment of BY$4,750 had an actual cost basis of $5,977 (BY$4,750 x 1.2583).

The principal advantage of the double-extension method is that it results in a very accurate cost index, assuming that each item has an actual base-year cost. Where a new item for which a base-year cost is not available enters the pool, that item must generally be extended either using a “reconstructed” base-year cost or, if a base-year cost cannot be reconstructed, its cost for the year in which it was introduced into the pool. Reg § 1.472-8(e)(2)(iii).

Another method used to develop this index is the “link-chain” method. Under the link-chain method, the cost index is computed in two steps. The first step is very similar to the procedure described and illustrated for the double-extension method. But instead of double-extending the items at current-year costs and base-year costs, they are extended at their preceding-year costs and their current-year costs. The resulting index reflects the cost changes that have taken place during the past year. The cumulative index
for the current year is then, in effect, derived by multiplying the annual
indexes for the current and all preceding years back to the base year. Each
year’s cumulative index can thus be characterized as a “link” in a “chain”
that connects the current year with the base year.

The principal advantage of the link-chain method is that it deals much
more effectively with the introduction of new items into the LIFO inventory
pool. For these items, only the cost at the beginning of the year must be
known and there is no need to reconstruct a base-year cost where none
existed. The principal objection to the link-chain method is that the
accuracy of each year’s index is dependent upon the accuracy of all of the
indexes computed for prior years. This gives rise to two concerns. First, any
errors made in the computation of the index in any prior year will
permanently distort all future indexes. Second, the link-chain index will
accurately reflect the cost changes of the items in the current year’s ending
inventory only if either (1) the costs of all of the items in the pool have
been rising at a uniform rate, or (2) the relative number of units of each
item in the pool (i.e., the item mix) does not change from one year to the
next.

Indexes developed using the double-extension or link-chain methods are
internal indexes that reflect changes in inventory replacement costs actually
experienced by the taxpayer. In practice, the process of developing these
internal LIFO indexes can be extremely complex, time-consuming, and costly.
were precluded from availing themselves of the relatively straightforward and
efficient alternative of using the price-change indexes developed and
published each month by the U.S. Bureau of Labor Statistics (BLS) in lieu of
developing their own internal indexes. (Prior to 1981, only department stores
using the retail method were generally permitted to use BLS retail price
indexes in lieu of internally developed indexes. Other taxpayers, such as
specialty stores, could use BLS indexes only if they could demonstrate the
"accuracy, reliability, and suitability of such indexes." Rev. Rul. 75-181,
1975-1 C.B. 150.)

In early 1981, the Treasury Department issued proposed regulations
which allowed taxpayers to use indexes published by the BLS in the "CPI
Detailed Report" or "Producer Prices and Price Indexes." Congress responded
approvingly by enacting section 472(f), which directed the Treasury to
"prescribe regulations permitting the use of suitable published governmental
indexes in such manner and circumstances as determined by the Secretary" for
the purposes of implementing the dollar-value LIFO method.

Under Regulation section 1.472-8(e)(3), any taxpayer electing to use
the dollar-value method can elect to use the “inventory price index
computation” method (IPIC method). Under this method, the taxpayer must
compute a separate inventory price index for each dollar-value pool using the
appropriate indexes published by the BLS and employing the procedures set
forth in these regulations. The resulting index is then used to (1) convert
the total current-year cost of the items in the pool to their total base-year
cost in order to determine whether there has been an increment or decrement,
and, if there has been an increment, to (2) determine the LIFO inventory
value of that increment. See, generally, W. Eugene Seago, Does It Take an
Engraved Invitation for Taxpayers to Adopt IPIC-LIFO? 94 Tax Notes (TA) 1027
(Feb. 25, 2002).
Figure 2c shows the computation of the taxpayer’s ending Inventory and its Cost of Goods Sold for 2004 through 2006.

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Ending Inventory</th>
<th>Cost of Goods Sold</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Layer</td>
<td>Quantity (in Base-Year Dollars)</td>
</tr>
<tr>
<td>2004 Base-Year 2004</td>
<td>BY$ 8,250</td>
<td>$1.0000</td>
</tr>
<tr>
<td>Totals:</td>
<td>$10,250</td>
<td>$10,445</td>
</tr>
<tr>
<td>2005</td>
<td>BY$ 2,000</td>
<td>$1.0976</td>
</tr>
<tr>
<td>2005</td>
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<tr>
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III. EVENTS TRIGGERING LIFO RECAPTURE UNDER SECTION 1363(D)

Although there are several scenarios under which a C corporation might avoid corporate-level taxes on its LIFO reserve by converting to S status, the language of section 1363(d)(1) anticipates only one — the making of an S election by a C corporation that maintains one or more LIFO inventories for the taxable year immediately preceding its first taxable year as
an S corporation.\textsuperscript{55} The Service has ruled that section 1363(d) also applies where a C corporation voluntarily discontinues its use of the LIFO method within the four taxable years prior to the first year for which its S election is effective,\textsuperscript{56} in which case the remaining balance of any positive “section 481(a) adjustment”\textsuperscript{57} attributable to that change must be included in the

\textsuperscript{55}I.R.C. § 1363(d)(1).

\textsuperscript{56}Rev. Proc. 2002-9, 2002-1 C.B. 327, app. § 10.01(3)(b). If the discontinuation of the LIFO method is effective for the converted corporation’s first year as an S corporation, section 1363(d) applies in the normal way (i.e., the LIFO recapture amount is included in the converting corporation’s gross income for its last taxable year as a C corporation, the resulting incremental tax on that income is payable in four equal annual installments, and corresponding adjustments are made to the corporation’s basis in the LIFO inventory). The stepped-up basis that results from the application of section 1363(d) is taken into account by the S corporation in computing the amount of any additional section 481(a) adjustment that might result upon its discontinuation of the LIFO method. Rev. Proc. 2002-9, 2002-1 C.B. 327, app. § 10.01(3)(a); see also infra note 57 (overview of section 481).

\textsuperscript{57}A change in a taxpayer’s method of accounting typically creates the potential for the duplication of omission of gross income, deductions, or both. For example, if a cash method taxpayer changes to the accrual method, income that it has earned but not collected as of the effective date of the change would not generally be recognized as income for any year: the income accrued while the taxpayer was using the cash method but be received when the taxpayer is using the accrual method. For the same reasons, a cash method taxpayer’s accrued, but unpaid trade accounts payable would generally never be deductible to the extent that they are paid after the taxpayer’s change to the accrual method. (Conversely, a change from the accrual method to the cash method would generally result in a duplication of income and a duplication of deductions with respect to the taxpayer’s trade accounts receivable and payable.)

Section 481(a) prevents these distortions by requiring that a taxpayer changing from one method of accounting to another recognize a special gross income or deduction item equal to the net amount of all the omissions and duplications that would otherwise result from the change. Section 481(a) generally requires that the entire amount of this “section 481(a) adjustment” be included in computing the taxpayer’s taxable income for the first year in which the change is effective (subject, however, to section 481(b), which limits the amount of tax where the section 481(a) adjustment is substantial). However, where the change in method is initiated by the taxpayer, rather than by the Service, the Service, under the authority of section 481(c), generally allows the taxpayer to recognize a positive section 481(a) adjustment ratably over a period of four consecutive years, beginning with the year of the
corporation's gross income for its last taxable year as a C
corporation. Any incremental tax imposed on this amount is
generally payable in four equal annual installments, as provided
in section 1363(d)(2).

change. If the year of change or any tax year during the section 481(a)
adjustment period is a short tax year, the section 481(a) adjustment must be
included in income as if the short tax year were a full 12-month year. A
taxpayer may elect to use a one-year adjustment period in lieu of the four-
year adjustment period for a positive adjustment that is less than $25,000.
Rev. Proc. 2002-9, 2002-1 C.B. 327, § 5.04(1), (2), (3)(a); Rev. Proc. 97-27,
1997-1 C.B. 680, §§ 5.02(3), 7.02, 7.03(1) (Effective for taxable years
ending on or after December 31, 2001, negative section 481 adjustments are
generally recognized in their entirety in the year of the change. Rev. Proc.
2002-19, 2002-1 C.B. 696, § 2.02.).

Note, however, that since a corporation’s conversion to or from S
status is not treated as a “cessation” of a trade of business or as a
“termination” of the taxpayer, a C corporation that elects S status is not
required to accelerate the recognition of a positive section 481(a)
adjustment if and to the extent that it is not attributable to a change from
a LIFO method to a non-LIFO method. Rev. Proc. 2002-9, 2002-1 C.B. 327, §
5.04(3)(c)(iii). Instead, any section 481(a) adjustments that result from
other accounting method changes (whether made before or after the
corporation’s conversion to or from S status) are recognized at the normal
time.

Where the corporation was a C corporation that converted to S status,
the section 481(a) adjustments that are included in the computation of its
post-conversion taxable income will be classified as section 1374 built-in
gain or built-in loss “to the extent the adjustment relates to items
attributable to periods before the beginning of the recognition period . . .
.” Reg. § 1.1374-4(d); see also Argo Sales Co. v. Commissioner, 105 T.C. 86
(1995); Rondy, Inc. v. Commissioner, 70 T.C.M. (CCH) 332, 1995 T.C.M. (RIA) ¶
95,372, aff’d per curiam 117 F.3d 1421 (6th Cir. 1997).

By contrast, where the corporation was an S corporation that converted
to C status, the section 481(a) adjustments that are included in the
computation of its post-conversion taxable income will generally be taken
into account in computing its corporate-level tax liability, regardless of
whether or not such adjustments are attributable to periods during which the
corporation was an S corporation. See infra Part IV.D.2. (“Pre-Immersion
Accruals of the LRA”).

Rev. Proc. 2002-9, 2002-1 C.B. 327, app. § 10.01(3)(b). However, the
entire incremental tax is due immediately where the converting corporation is
required to take the remaining balance of the section 481(a) adjustment into
account in its last taxable year as a C corporation under one of the
acceleration provisions listed in section 5.04(3)(c) of Revenue Procedure
2002-9 (i.e., cessation of the trade or business that gave rise to the
section 481(a) adjustment, or termination of the corporation, other than in a
nontaxable carryover-basis transaction to which section 381(a) applies). Id.
A. Events that Do Not Trigger Section 1363(d) Recapture

As a general rule, the statute does not except a taxpayer’s LIFO reserves from the nonrecognition umbrella otherwise provided for upon the occurrence of certain nonrecognition events. LIFO recapture is not required (or permitted) when, for example, an S corporation’s S election is revoked or terminated, or when LIFO inventory is transferred to a C or S corporation in a nontaxable section 351 exchange or to a partnership or limited liability company in an exchange that qualifies under section 721. Nor is recapture of the transferor’s LIFO reserves

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The rationale for allowing a further extension of the payment of taxes on the balance of the section 481(a) adjustment recognized in the corporation’s last C year is not apparent. Both Revenue Procedure 2002-9 and section 1363(d) provide for a four-year period over which the taxes resulting from the recognition of the LIFO recapture amount are to be paid. Where the LIFO-to-FIFO change occurred in the first, second, or third year preceding the converting corporation’s final C year, Revenue Procedure 2002-9 deals with the overlap by adding another three years under section 1363(d) to the one, two, or three years that the taxes on the remaining section 481(a) adjustment balance have already been deferred.

When a LIFO-method S corporation’s election is revoked or terminated or when LIFO inventory is transferred by a non-C corporation transferor to a C corporation in a section 351 exchange, all of the appreciation that built up in the value of that inventory outside of C corporation solution (i.e., during the time when the recognition of that gain would not have been subject to corporate-level taxes) becomes subject to corporate-level taxation when that “inbound” built-in gain is subsequently recognized by the C corporation. See infra Part IV.D.2. (“Pre-Immersion Accruals of the LRA”). This unfortunate consequence is by no means limited to gain built into the value of LIFO inventory.

Any pre-contribution LIFO reserve that is subsequently recognized by a transferee partnership must generally be allocated to the transferor partner member under section 704(c). See also I.R.C. § 737. No such special
generally required (or permitted) (1) when LIFO inventory is disposed of in an assets-for-stock exchange that qualifies as a nontaxable reorganization under section 368 (where the transferor is an S corporation, or where both the transferor and transeree are C corporations), or (2) when LIFO inventory is distributed by a subsidiary corporation to its parent in a liquidation that qualifies under sections 332 and 337 (where the parent and subsidiary corporations are both C corporations or where an S corporation forms a new subsidiary with respect to which it makes a “qualified subchapter S subsidiary” (QSub) election that takes effect immediately upon the subsidiary’s formation).

allocations are required (or permitted) where LIFO inventory is transferred to a C corporation or to an S corporation under section 351.

As in the case of a section 351 transfer of LIFO inventory by a non-C corporation transferor to a new or existing C corporation (see supra note 60), where the transeree is a C corporation, all of the appreciation that built up in the value of that inventory while it was held by the transferor S corporation (i.e., outside of C corporation solution) becomes subject to corporate-level taxes when that unrealized built-in gain is subsequently recognized by the transferee C corporation. See infra Part IV.D.2. (“Pre-Immersion Accruals of the LRA”).

A QSub is any domestic corporation that would be eligible to make an S election if its stock were held directly by the shareholders of its parent S corporation, but only if (1) the corporation is wholly owned by an S corporation, and (2) the S corporation parent elects to treat the subsidiary as a QSub. I.R.C. § 1361(b)(3)(B); Reg. § 1.1361-2(a). A QSub is not treated as a separate corporation. Its assets, liabilities, and items of income, deduction and credit (including its accumulated earnings and profits, passive investment income and built-in gains) are treated as those of its parent S corporation. I.R.C. § 1361(b)(3)(A). Transactions between the parent and its QSubs are ignored.

If an S corporation makes a valid QSub election with respect to an existing C corporation subsidiary, that subsidiary is treated as having liquidated into the S corporation. See I.R.C. §§ 332, 337. If an S corporation forms a subsidiary and makes a valid QSub election for that
subsidiary that is effective immediately upon the date of the subsidiary's formation, the transfer of assets to the subsidiary and the deemed liquidation are both disregarded - the subsidiary will be deemed to be a QSub from its inception and its assets will be deemed to have been held continuously by the S corporation. Reg. § 1.1361-4(a)(2).


These nonrecognition provisions of Subchapter C apply not only to C corporations, but to S corporations as well. I.R.C. § 1371(a) (“Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.”).

The transactions described in this sentence would not normally trigger the taxable recognition of the transferor corporation’s LIFO reserves for two reasons. First, section 361(a) generally exempts the transferor corporation from the recognition of any gain or loss when it disposes of its assets in a nontaxable section 368 reorganization. Similarly, section 337 generally exempts a subsidiary from gain or loss recognition on any assets it distributes to its parent corporation when it liquidates under section 332.

Second, in each of these transactions, other than a divisive Type D or Type G reorganization, the transferee corporation is generally permitted (and required) to use the transferor’s LIFO method to account for the LIFO inventories it receives from the transferor corporation, and the transferor’s bases in those inventories (including their LIFO layer structures) carry over intact to the transferee. I.R.C. §§ 381(c)(5), 362(b).

However, where the transferor and transferee use different methods of accounting for their respective inventories, Regulation section 1.381(c)(5)-1 provides rules for determining the inventory method or methods the transferee corporation must prospectively use. Under some circumstances, where (1) either the transferor corporation or the transferee corporation uses the LIFO method, (2) the other corporation uses a non-LIFO method, (3) the businesses of the two are integrated following the acquisition, and (4) the non-LIFO method is determined to be the “principal method,” the LIFO method theretofore used to account for the LIFO inventory must be changed to the non-LIFO method, and the LIFO reserve must be recaptured as a section 481(a) adjustment. It is generally thought that the entire amount of this section 481(a) adjustment must be included in the income of the acquiring corporation in the year of the merger, regardless of whether it is the acquiring or the acquired corporation’s LIFO inventory that is being adjusted. See Reg. § 1.381(c)(5)-1(e)(4). But see Charles Davenport and W. Eugene Seago, The Section 351 Pendulum in the LIFO Pit, 80 Tax Notes (TA) 1325 (Sept. 14, 1998), where the authors suggest that taxpayers in such circumstances may have grounds to argue for a four-year spread of the section 481(a) adjustment. They also suggest that LIFO recapture under these section 381 regulations might be easily avoided where the non-LIFO method participant makes a timely LIFO election that is effective for the year in which the acquisition takes place.

Section 381(c)(5) does not apply to divisive Type D or Type G reorganizations or to section 351 exchanges, and there is no statutory mandate requiring or permitting the carryover of the transferor’s inventory accounting method. Consequently, notwithstanding the transferor’s use of the LIFO method with respect to inventory it transfers to the transferee
It is clear from a reading of the statute and its legislative history that section 1363(d) does not create a blanket exception to these nonrecognition provisions and that it was intended to apply only to LIFO inventory held by a C corporation, and only if and when that inventory is removed from C corporation solution in an event that would otherwise be nontaxable. The Service has made this seemingly obvious point clear in a number of private letter rulings that expressly conclude that LIFO recapture is not required under section 1363(d) where (1) LIFO inventory held by an individual, an S corporation, a partnership, or a LLC is disposed of in a transaction that qualifies as nontaxable under other provisions of the Code, or where (2) when the smoke clears, the LIFO inventory continues to be held by a C corporation.

corporation, if the transferee wants to use LIFO with respect to that inventory it must make a timely election to do so (usually by filing a timely Form 970). Textile Apron Co. v. Commissioner, 21 T.C. 147 (1953), acq. 1954-1 C.B. 7. Even if the transferee does make a timely LIFO election, the Service has ruled that only the transferor’s basis in the inventory (as a whole) carries over to a transferee corporation that does not already have a LIFO election in effect with respect to that type of inventory; the transferor’s base period and layers disappear and the transferee treats the inventory as current-year purchases at the transferor's average costs. Rev. Rul. 70-564, 1970-2 C.B. 109. The collapsing of high-basis newer layers and low-basis older layers can have the undesirable effect of accelerating the recognition of income if and when the new base layer is subsequently invaded.

But where the transferee is an existing corporation that is already using LIFO, the transferor’s base year and layer structure carryover to the transferee, just as they do under section 381(c)(5). Joseph E. Seagram & Sons Inc. v. Commissioner, 394 F.2d 738 (2d Cir. 1968), rev’g 46 T.C. 698 (1966); Rev. Rul. 70-565, 1970-2 C.B. 110. For section 351 and section 721 transfers of LIFO inventories accounted for by the transferor and the transferee under the dollar-value method, see Regulation section 1.472-8(h).
In Private Letter Ruling 1990-39-005 (June 12, 1990), for example, a sole proprietorship using the LIFO method incorporated under section 351 and immediately elected S corporation status for the first year of its existence. The ruling held that there was no section 1374 built-in gain potential because the corporation was never a C corporation and that Congress did not intend section 1363(d) to apply where there is no built-in gain that might otherwise escape section 1374. Similarly, the Service ruled that section 1363(d) did not apply where an S corporation transferred assets, including LIFO inventories, to a newly formed, wholly owned subsidiary corporation with respect to which the S corporation immediately made a QSub election under section 1361(b)(3)(B).

In this regard, it is crucial that the transferee corporation’s S election be effective from the beginning of the corporation’s tax year in which it receives the LIFO inventory. As noted elsewhere in this Article, there is no statutory, regulatory, or judicial authority that would permit the bifurcation of the LIFO reserve into the amounts that accrued inside and outside C corporation solution. But see infra note 207. Consequently, both the pre-exchange LIFO reserve and the post-exchange LIFO reserve would be subject to section 1363(d) if the transferee corporation was a C corporation at the time of the exchange and subsequently makes an S election. See infra Part IV.D.2. (“Pre-Immersion Accruals of the LRA”).

Note, however, that in 1996, Congress empowered the Service to accept a late S election (or even waive the absence of an election) and to treat as valid an otherwise invalid election. I.R.C. § 1362(b)(5). The Service can apply these powers retroactively all the way back to 1983. Similarly, the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, amended section 1362(f)(1)(A) to grant the Service the authority to waive inadvertently invalid QSub elections.

Nor does section 1363(d) apply to nontaxable acquisitive or divisive reorganizations in which the transferor and transferee corporations are both S corporations. In Private Letter Ruling 1989-46-052 (Aug. 22, 1989), for example, the Service held that the nontaxable Type A statutory merger\textsuperscript{67} of a LIFO-method S corporation into another LIFO-method S corporation did not trigger LIFO recapture under section 1363(d).\textsuperscript{68} Similarly, in Private Letter Ruling 2002-44-014 (Nov. 1, 2002), section 1363(d) was held to be inapplicable where the stock of 11 commonly owned S corporations was acquired by a new S corporation holding company in a nontaxable acquisitive Type D reorganization\textsuperscript{69} and the acquisition was immediately followed by the acquiring S corporation’s election under section 1361(b)(3) to treat the subsidiaries as QSubs.\textsuperscript{70} Section 1363(d) would

\footnotesize

\begin{itemize}
\item assets to the subsidiary and the deemed liquidation are disregarded. Reg. § 1.1361-4(a)(2)(i). Since the exchange and deemed liquidation are stepped together, Revenue Ruling 70-564, 1970-2 C.B. 109, should be inapplicable and the layer structure, etc., of the QSub’s LIFO inventory should be preserved intact. See supra note 64.
\item I.R.C. § 368(a)(1)(A). Throughout the remainder of this Article, “Type A,” “Type B,” etc. reorganizations refer to reorganizations described in section 368(a)(1)(A), section 368(a)(1)(B), etc.
\item I.R.C. §§ 368(a)(1)(D), 354(b)(1).
\item Where a corporation acquired the stock of the target corporation and immediately liquidated the target pursuant to a prearranged plan, the two steps were not treated independently. The transaction was instead treated as an acquisition of the target corporation’s assets. Rev. Rul. 67-274, 1967-2 C.B. 141; Rev. Rul. 76-123, 1976-1 C.B. 94; T.A.M. 97-43-001 (Jun. 4, 1997);
\end{itemize}

\textsuperscript{67}I.R.C. § 368(a)(1)(A). Throughout the remainder of this Article, “Type A,” “Type B,” etc. reorganizations refer to reorganizations described in section 368(a)(1)(A), section 368(a)(1)(B), etc.

\textsuperscript{68}See also P.L.R. 88-43-026 (Aug. 1, 1988); P.L.R. 91-23-049 (Mar. 13, 1991); P.L.R. 91-18-029 (Feb. 6, 1991); P.L.R. 92-13-026 (Dec. 30, 1991) (all ruling that section 368(a)(1)(F) reincorporations of a LIFO-method S corporation did not terminate the transferor corporation’s S election or trigger LIFO recapture under section 1363(d)).

\textsuperscript{69}I.R.C. §§ 368(a)(1)(D), 354(b)(1).

\textsuperscript{70}Where a corporation acquired the stock of the target corporation and immediately liquidated the target pursuant to a prearranged plan, the two steps were not treated independently. The transaction was instead treated as an acquisition of the target corporation’s assets. Rev. Rul. 67-274, 1967-2 C.B. 141; Rev. Rul. 76-123, 1976-1 C.B. 94; T.A.M. 97-43-001 (Jun. 4, 1997);
likewise be inapplicable with respect to the LIFO inventories held by any of the acquired S corporation’s QSubs when, as part of the nontaxable Type A, Type C, or acquisitive Type D reorganization, all of the stock of the QSubs is transferred to the acquiring S corporation.\footnote{Note, however, that the transferor S corporation’s QSub election does not automatically carry over with the subsidiary to the acquiring S corporation. If a timely QSub election is not made by the acquiring S corporation (or by an acquiring C corporation that simultaneously makes an S election for itself), any gain built-into the QSub’s LIFO inventory as of the date of the transfer will be immersed in C corporation solution.}

\footnote{Note, however, that the transferor S corporation’s QSub election does not automatically carry over with the subsidiary to the acquiring S corporation. If a timely QSub election is not made by the acquiring S corporation (or by an acquiring C corporation that simultaneously makes an S election for itself), any gain built-into the QSub’s LIFO inventory as of the date of the transfer will be immersed in C corporation solution.}


But where an S corporation purchases all of the stock of a solvent C corporation in a qualified stock purchase (within the meaning of section 338(d)(3)), and then, as part of the same plan, immediately makes a QSub election for that corporation, the purchase of the stock and the deemed liquidation are not stepped together. Reg. § 1.1361-4(a)(2)(ii), Ex. (1). See infra note 86.

\footnote{Note, however, that the transferor S corporation’s QSub election does not automatically carry over with the subsidiary to the acquiring S corporation. If a timely QSub election is not made by the acquiring S corporation (or by an acquiring C corporation that simultaneously makes an S election for itself), any gain built-into the QSub’s LIFO inventory as of the date of the transfer will be immersed in C corporation solution.}

The loss of the acquired subsidiary corporation’s QSub status can be avoided only if the acquiring S corporation makes a new QSub election that is effective immediately upon its acquisition of the subsidiary (and immediately after the termination of the transferor’s QSub election). Regulation section 1.1361-5(c)(2) automatically waives the five-taxable-year waiting period described in section 1361(b)(3)(D) where (1) a subsidiary corporation’s QSub election terminates, (2) immediately following the termination, the corporation is otherwise eligible to have a QSub election made for it, and (3) the new QSub election is made effective immediately following the termination of the old QSub election. Rev. Rul. 2004-85, 2004-33 I.R.B. 189.

Otherwise, the QSub election terminates at the end of the day of the transfer and the acquiring S corporation is treated as if it had first acquired the QSub’s assets and had then transferred those assets to the former QSub (now a C corporation subsidiary of the acquiring S corporation) in exchange for its stock under section 351. The former QSub will not be eligible to be treated as a QSub (or as an S corporation) before the expiration of the waiting period described in section 1361(b)(3)(D) (generally five taxable years). \textit{Id.}

If the acquiring S corporation fails to make a timely QSub election, relief may be available under Revenue Procedure 2004-49, 2004-33 I.R.B. 210.

Where an S corporation with one or more QSubs changes its “identity, form, or place of incorporation” under section 368(a)(1)(F), its QSub election(s) are not terminated. Rev. Rul. 2004-85, 2004-33 I.R.B. 189.
In Private Letter Ruling 1994-24-046 (Mar. 22, 1994), the Service ruled that neither the distributing S corporation nor the newly formed controlled corporation would be subject to LIFO recapture under section 1363(d) where, in a nontaxable split-off division under sections 368(a)(1)(D) and 355, the distributing S corporation transferred LIFO inventory to the new controlled corporation and the shareholders of the controlled corporation made a timely S election that was effective for that corporation’s first taxable year.\(^{72}\)

Finally, in Private Letter Ruling 1998-27-020 (July 2, 1998), a C corporation transferred LIFO inventory to a new C corporation in exchange for all of its stock under section 351. Immediately thereafter, the transferor corporation made an S election, but the transferee subsidiary continued to operate as a C corporation. Since the LIFO inventory remained in C corporation solution, neither corporation was required to recognize the LIFO recapture amount built into the transferred inventory.

B. **LIFO Inventory Acquired by an S Corporation from a C Corporation in a Nontaxable Asset Acquisition**

\(^{72}\)See also P.L.R. 2000-50-043 (Sept. 20, 2000); P.L.R. 96-16-023 (Jan.
In the years since its enactment, deficiencies in the statutory language delineating the scope of the application of section 1363(d) have become glaringly apparent. The statute inexplicably fails to expressly require LIFO recapture where a new or existing S corporation acquires the LIFO inventory of a C corporation in a nontaxable carryover-basis transaction, or where a C corporation owns an interest in a partnership holding LIFO inventories as of the effective date of its S election (or as of the date of the transfer of the partnership interest to an S corporation in a nontaxable carryover-basis transaction). As evidenced by the facts before the Sixth Circuit in United Dairy Farmers, Inc. v. United States\textsuperscript{73} and by the holding of the Eleventh Circuit in Coggin Automotive Corp. v. Commissioner,\textsuperscript{74} the relative ease with which taxpayers have exploited these gaps has given rise to the specter of wholesale avoidance.

1. Potential for Abuse

In United Dairy Farmers, the shareholders of United Dairy Farmers, Inc. (UDF), a family owned C corporation with ten wholly owned subsidiaries, decided to convert UDF into an S

\textsuperscript{73}267 F.3d 510 (6th Cir. 2001) [hereinafter United Dairy Farmers].
corporation. Its tax advisors told the shareholders that while UDF would be subject to a significant section 1363(d) LIFO recapture tax if it made an S corporation election, this tax could easily be avoided by forming a new S corporation into which UDF and its subsidiaries could then merge. Under the reorganization provisions, the transfer of assets by UDF and its subsidiaries to the new S corporation would qualify as a nontaxable acquisitive Type D reorganization and the transferors’ tax bases in their respective assets, including their LIFO inventories, would carryover to the new S corporation. Under section 381(c)(5), the new S corporation would continue to use the LIFO method to account for these inventories.

The tax advisors believed this strategy would be effective in circumventing section 1363(d). First, then and now, the statute itself requires LIFO recapture only when a LIFO-method C corporation makes an S election. Second, at the time of the proposed UDF transaction, the regulations were silent as to whether section 1363(d) would apply where a LIFO-method C corporation merged into an S corporation in a nontaxable carryover-basis transaction. Finally, in 1988, the year after

\[74,292 F.3d 1326 (11th Cir. 2002), rev’g 115 T.C. 349 (2000) \text{[hereinafter Coggin Automotive]}

\[75 \text{See I.R.C. §§ 368(a)(1)(D), 354(b)(1).}

\[76 \text{I.R.C. § 362(b).} \]
section 1363(d) was enacted, Congress added section 1374(d)(8), which extended the scope of section 1374 to the gains built into the value of assets received by an S corporation from a C corporation in a nontaxable asset acquisition, but it did not make a corresponding amendment to section 1363(d) to deal with analogous situations that could arise under that provision. UDF’s tax advisors argued that it was logical to infer that Congress had made an affirmative decision to exempt such transactions from the LIFO recapture provisions of section 1363(d).78

Pursuant to the advice of its tax advisors, UDF created a new S corporation, named Uncle Bud's Fried Dough, Inc. (Uncle Bud's). Uncle Bud’s was a shell corporation that, prior to the subsequent merger, conducted no operations and held no inventory. On December 31, 1992, UDF and its ten subsidiaries

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77Section 1374(d)(8) was added by The Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, 102 Stat. 3342.

78The Service apparently agreed:

We believe that it is significant that when enacting TAMRA, Congress amended section 1363 by adding subsection (d)(4)(D), which addressed LIFO inventory recapture by a C corporation which formerly belonged to a controlled group of an affiliated group of corporations. Because Congress addressed section 1363 by amending that section in an unrelated area, it is unlikely that Congress intended that section 1374(d)(8) to extend by implication to section 1363(d). Furthermore we believe that the amendment of section 1363(d) to address an unrelated issue lessens the likelihood that Congress' failure to include in section 1363 a provision similar to that of section 1374(d)(8) was an inadvertent oversight. Thus, we conclude that Congress arguably did not intend that section 1363(d) be read together with section 1374(d)(8).
were merged into Uncle Bud's in a nontaxable acquisitive Type D reorganization. Immediately after the merger, Uncle Bud's changed its name to United Dairy Farmers, Inc. Post-merger UDF had the same shareholders, officers, and directors as the pre-merger UDF. The pre-merger UDF, along with its ten subsidiaries, ceased to exist as part of the merger.

UDF’s strategy seems to have been effective in avoiding LIFO recapture under section 1363(d). The Service apparently either failed to raise this issue with the taxpayer or conceded it prior to trial. Nevertheless, the facts of the case serve to illustrate the impunity with which LIFO recapture under section 1363(d) could be avoided in the absence of remedial legislation, administrative ruling, or case law.

2. The Section 1363(d) Regulations

On August 18, 1993, the Treasury issued the first proposed regulations under section 1363(d). The principal effect of these regulations was to extend the scope of the application of section 1363(d) to C corporations that transferred LIFO

1993 WL 1468128.

79The issues before the court had to do with the proper tax treatment of (1) the fee that UDF paid to its accounting firm for work performed by the
inventory to a new or pre-existing S corporation in an otherwise nontaxable carryover-basis transaction. These regulations reflected the Treasury’s concern that taxpayers, like the taxpayer in United Dairy Farmers, could otherwise use the reorganization provisions to circumvent section 1363(d) and permanently escape corporate-level taxes on the LIFO reserve that built up during the corporation’s C years.\textsuperscript{80} Under these regulations, which were finalized on October 6, 1994,\textsuperscript{81} section 1363(d) requires a LIFO-method C corporation to recognize its LIFO recapture amount as gross income in the year that it transfers LIFO inventory to an S corporation in a nontaxable carryover-basis transaction, i.e., in a “nonrecognition transaction” (as defined in section 7701(a)(45)) in which the transferred assets constitute “transferred basis property” (as defined in section 7701(a)(43)).\textsuperscript{82}

\textsuperscript{80}Recapture of LIFO Benefits, 58 Fed. Reg. 43827 (proposed Aug. 18, 1993) (to be codified at 26 C.F.R. pt. 1) (“If a corporation could avoid the LIFO recapture amount by merging with either a new or preexisting S corporation, the reorganization provisions of the Code could be used to circumvent both sections 1363(d) and 1374.”).

\textsuperscript{81}Regulation section 1.1363-2(a)(2) applies to transfers made after August 18, 1993. Reg. § 1.1363-2(g)(2). But see P.S.A. 1999-220-11 (Feb. 23, 1999) (“[S]upport exists in the legislative history . . . .” for the application of this rule to transfers occurring after the enactment of section 1363(d) and before the effective date of Regulation section 1.1363-2(a)(2)). But see supra note 78.

\textsuperscript{82}Reg. § 1.1363-2(a)(2). A section 7701(a)(45) nonrecognition transaction is any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for income tax purposes. Transferred basis property under section 7701(a)(43) is property having a
The transactions to which these rules are applicable include Type A reorganizations (statutory merger or consolidation), Type C reorganizations (stock-for-asset acquisition or "practical merger"), Type D reorganizations (both acquisitive and divisive\textsuperscript{83}), Type G reorganizations (both acquisitive and divisive insolvency reorganizations), and section 332 liquidations (liquidation of an 80%-controlled subsidiary into its parent\textsuperscript{84}).\textsuperscript{85} Section 1363(d) would also apply basis determined under any income tax provision that provides that the transferee’s basis in property acquired from the transferor is determined in whole or in part by reference to the property’s basis in the transferor's hands.

\textsuperscript{83}The proposed regulations stated that the LIFO recapture amount would be recognized “in the last year of (the transferor C corporation’s) existence.” The final regulations changed this language to read “in the year of transfer” because in certain divisive reorganizations (i.e., spin-offs and split-offs qualifying under sections 368(a)(1)(D) and 355), the existence of the transferor corporation continues. T.D. 8567, 1994-2 C.B. 199.

\textsuperscript{84}At the time these regulations were issued, an S corporation could not own an 80% interest (as defined in section 1504(a)) in another corporation. I.R.C. § 1361(b)(2)(A) (pre-1997). This restriction was removed by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755.

\textsuperscript{85}These rules do not apply to a section 351 exchange because the transferee of a C corporation’s LIFO inventory cannot be an S corporation. Section 1361(b)(1)(B) does not permit an S corporation to have a C corporation as a shareholder.

Nor do these rules apply to a Type F reorganization. I.R.C. § 368(a)(1)(F) ("[A] mere change in identity, form, or place of organization of one corporation, however effected . . . ."). A Type F reorganization is treated as a nonevent for virtually all tax purposes. Under section 381(b), for example, the tax year of the transferor corporation does not close as of the date of the transfer. Presumably, this also means that the first day of the transferor’s tax year is deemed to be the first day of the transferee’s tax year for the year of the transfer. Although there does not appear to be any authority bearing directly on this point, it seems clear that a C corporation could not, in a Type F reorganization, transfer its assets mid-year to a new transferee corporation for which an S election is already in effect. If the transferor is a C corporation, the transferee would have to wait until after the end of the year of the reorganization to elect S status, in which case the C-to-S conversion rule of the statute would apply.
where an S corporation makes a QSub election with respect to an existing wholly-owned LIPO-method C corporation subsidiary.86

3. Overlap

LIFO recapture is required under both the section 1363(d) regulations and Regulation section 1.381(c)(5)-1(e)(4) where, for example, a LIFO-method C corporation transfers its assets to a FIFO-method S corporation in a nontaxable Type A, Type C, or acquisitive Type D reorganization under circumstances that require the transferor C corporation to change its LIFO method

86As previously observed, such elections are treated as if the subsidiary had completely liquidated, a transaction that will generally qualify as a nontaxable carryover-basis transaction under section 332. See supra note 63. However, if the subsidiary is insolvent, section 332 is not applicable and the deemed liquidation is fully taxable at the corporate (section 336) and shareholder (section 331) levels. Reg. § 1.1361-4(d), Ex. (5).

Where, as part of the same plan, an S corporation purchases all of the stock of a solvent C corporation for cash or notess from an unrelated person and then immediately makes a QSub election for that corporation, the purchase of the stock and the deemed liquidation are not stepped together (i.e., the purchase of the acquired corporation’s stock is not automatically recast as a deemed purchase of its assets). Reg. § 1.1361-4(a)(2)(ii), Ex. (1). Consequently, unless the purchasing S corporation makes a timely section 338(g) election (or, where the acquired C corporation is a subsidiary member of an affiliated group, unless the selling parent corporation and the acquiring S corporation jointly make a timely election under section 338(h)(10)), the acquired C corporation will not, on account of the sale of its stock by its shareholder(s), recognize any of the gain or loss built into any of its assets. When the purchasing S corporation’s subsequent QSub election triggers the acquired subsidiary’s deemed liquidation, section 337 will generally exempt the subsidiary from the recognition of any gains or losses built into the value of its assets. However, section 1363(d), as expanded by Regulation section 1.1363-2(a)(2), would require the recognition of any LIFO recapture amount built into the value of the subsidiary’s inventory as of the date of the liquidation.
to the transferee S corporation’s FIFO method. If section 1363(d) overrides the section 381(c)(5) regulations, (1) the transferor C corporation, not the transferee S corporation and its shareholders, will recognize the LIFO recapture amount as income, (2) this entire amount will be recognized in the transferor C corporation’s last taxable year, and (3) the resulting tax will be payable over in four equal interest-free annual installments. Conversely, if the section 381(c)(5) regulations govern the tax consequences, (1) the income recognized thereunder (as a section 481 adjustment) would probably have to be recognized in its entirety in the year in which the acquisition took place, (2) the amount so recognized would be recognized by the transferee S corporation (and subject to the section 1374 tax on built-in gains) and by its shareholders (who would be taxed individually on their respective shares of the net amount), and (3) the incremental corporate-level and shareholder-level taxes resulting from the

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87 See supra note 64.

88 Under section 381(b)(1)-(2), the transferor C corporation’s tax year closes as of the date of the transfer and the first installment of the incremental tax due under section 1363(d) would be payable on or before the unextended due date for its final tax return. The three succeeding installments would be payable by the transferee S corporation on or before the unextended due date for its tax returns for the three succeeding taxable years. I.R.C. § 1363(d)(2)(B); Reg. § 1.1363-2(d)(2). The three year period between the due dates for the first and last installment payments may be shortened where the asset transfer occurs other than on the last day of the transferee S corporation’s tax year. See infra Part V (“CALCULATION AND PAYMENT”).
recognition of this income would be due in full at the normal time.  

Although not entirely free of doubt, it seems reasonably clear that section 1363(d) should trump the section 381 regulations where the two overlap.

C. LIFO Inventory Held Indirectly Through a Partnership

1. Background: Coggin Automotive

Coggin Automotive Corporation (CAC) was a common parent holding company of a consolidated group that included five subsidiaries. Four of these subsidiaries owned and operated one or more new car or new truck dealerships. The fifth subsidiary owned a 50% general partnership interest in a partnership that owned and operated a new car dealership. Each of the subsidiaries and the partnership accounted for its new car and truck inventories under the dollar-value LIFO method.

89See supra note 64.

90Coggin Auto. Corp. v. Commissioner, 292 F.3d 1326 (11th Cir. 2002), rev’g 115 T.C. 349 (2000); see also T.A.M. 97-16-003 (Sept. 30, 1996).
Through an elaborate series of pre-arranged transactions,91 each of these subsidiaries transferred all of their respective assets, including their LIFO inventories, to a newly formed limited partnership in exchange for a 99% limited partnership interest.92 The one percent general partnership interest in each of these limited partnerships was held by one of the six new S corporations that had been formed a month earlier by CAC’s shareholders for this purpose.93 The formation of the limited partnerships was immediately followed by the tax-free liquidation of the subsidiaries,94 the distribution of their respective limited partnership interests to CAC, and CAC’s S election.

The sole issue in this case was whether section 1363(d) required CAC to recognize on the group’s final consolidated return the LIFO recapture amount built into (1) the LIFO inventories transferred by the CAC subsidiaries to their

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91Coggin Auto. Corp., 115 T.C. at 355-57. All of these transactions occurred within about a month (May 25 through June 27, 1993) and were carried out pursuant to instructions contained in a memo from the taxpayer’s accounting firm titled “Outline of Steps.”

92These exchanges were nontaxable under section 721. There were six limited partnerships in all. One of the subsidiaries had owned and operated two dealerships, each of which was transferred to a separate limited partnership.

93CAC’s three shareholders owned the stock of these S corporations in the same proportion as they held stock in CAC. These shareholders had transferred a $9,000 note to each of these corporations in exchange for all of the corporations’ stock. These notes were used by the S corporations to acquire their respective one percent general partnership interests in the limited partnerships. These notes were never paid.

94I.R.C. §§ 332, 337.
respective limited partnerships (and held by those partnerships at the time of the CAC’s S election) and (2) the LIFO inventory held by a long-standing partnership (in which the fifth CAC subsidiary held a 50% interest). Had CAC held the inventory directly, it clearly would have been subject to LIFO recapture. CAC argued, however, that the reorganization was undertaken for business purposes, and that section 1363(d) was not applicable because (1) CAC had itself never actually held any LIFO inventory, and (2) under the “entity concept” of partnership taxation, CAC could not be deemed to own the LIFO inventory that was actually held by its limited partnerships.

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95 Stated differently, the issue was whether a subsidiary C corporation, through a prearranged series of transactions culminating in the S election of its successor parent corporation, could avail itself of the nonrecognition provisions of section 721 and then sections 332 and 337 to circumvent the built-in gain tax regime of Subchapter S, and to thereby permanently elude corporate-level taxes on the income it deferred under the LIFO method of accounting throughout the years that it conducted its business as a C corporation.

96 Coggin Auto. Corp., 115 T.C. at 360. The taxpayer contended that the restructuring was motivated by the succession planning needs and desires of CAC’s majority shareholder and by the need to provide flexible ownership incentives to the key employees of the respective dealerships. At trial and on brief, the Service argued that the restructuring was motivated solely by the desire to avoid section 1363(d).

97 Section 1363(d) requires LIFO recapture only when the corporation making the S election “inventoried goods under the LIFO method” in the “last taxable year before the first taxable year for which the election under Section 1362(a) was effective.” As a holding company, CAC had not directly held any inventory at any time. Under the entity concept, CAC would not be deemed to hold any of the LIFO inventories that were actually owned by its subsidiary limited partnerships and section 1363(d) would not, according to CAC, be applicable. Conversely, under the aggregate concept, CAC would be deemed to have held its share of the LIFO inventories actually held by its subsidiary limited partnerships and section 1363(d) would require the recapture of the LIFO reserves built into that inventory at the time of CAC’s S election.
The Service argued that the taxpayer’s sole or principal objective for the series of transactions preceding CAC’s S election was to reap the benefits of that election while permanently avoiding corporate tax liability on the accumulated LIFO reserves of its various consolidated subsidiaries. It argued further that even if the transactions had been motivated by business purposes, and not by a principal tax avoidance purpose, CAC was subject to section 1363(d) as a matter of law under the “aggregate concept” of partnership taxation.

Although the Tax Court concluded that there was a real and substantial business purpose supporting the transactions, it applied the aggregate concept to treat CAC as the owner of the LIFO inventories that were actually held by its limited partnerships on the date of its S election. The Tax Court's analysis and holding were based on the legislative history of section 1363(d):

After considering the legislative histories of sections 1374 and 1363(d), we conclude that the application of the aggregate approach (as opposed to the entity approach) of partnerships in this case better serves Congress' intent. By enacting sections 1374 and 1363(d), Congress evinced an intent to prevent corporations from avoiding a second level of taxation on built-in gain assets by converting to S corporations. Application of the aggregate approach to section 1363(d) is consistent with Congress' rationale for enacting this section and operates to prevent a corporate taxpayer from using the LIFO method of accounting to permanently avoid gain recognition on appreciated assets. In contrast, applying the entity approach to section 1363(d) would potentially allow a
corporate partner to permanently avoid paying a second level of tax on appreciated property by encouraging transfers of inventory between related entities. This result clearly would be inconsistent with the legislative history of sections 1363(d) and 1374 and the supersession of the General Utilities doctrine . . . .

Here, as stated, both the legislative history and the statutory scheme of section 1363(d) mandate the application of the aggregate approach.98

Having so held, the Tax Court applied section 1363(d) to require CAC to recapture the LIFO reserves built into the inventories held by its partnerships.

On appeal, the Eleventh Circuit rejected the Tax Court’s application of the aggregate approach and held for the taxpayer. Under a strict construction of the literal language of section 1363(d), the Eleventh Circuit concluded that LIFO recapture is

98Coggin Auto. Corp. v. Commissioner, 115 T.C. 349, 363-65 (2000), rev’d 292 F.3d 1326 (11th Cir. 2002). In reaching its decision, the Tax Court followed prior decisions of several courts. Casel v. Commissioner, 79 T.C. 424 (1982) (applying the aggregate approach to disallow losses between related parties under section 267); Holiday Village Shopping Ctr. v. United States, 773 F.2d 276 (Fed. Cir. 1985) (applying the aggregate approach to require depreciation recapture upon a corporation’s distribution of a partnership interest to its shareholders); Unger v. Commissioner, 936 F.2d 1316 (D.C. Cir. 1991) (applying the aggregate approach to determine whether the corporation maintained a permanent establishment in the United States).

The Tax Court distinguished these decisions from others that had embraced the entity approach by contrasting the relevant Congressional intent behind the provision involved in each case. See P.D.B. Sports, Ltd. v. Commissioner, 109 T.C. 423 (1997) (application of section 1056); Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, 564 (1979), aff’d 633 F.2d 512 (7th Cir. 1980) (applying the entity approach in determining whether expenditures were deductible under Section 162 or were nondeductible start-up expenditures); Brown Group, Inc. & Subs. v. Commissioner, 77 F.3d 217 (8th Cir. 1996), rev’g 104 T.C. 105 (1995) (holding that the entity approach, rather than the aggregate approach, should be used in characterizing income earned by a partnership as Subpart F income or non-Subpart F income). The Tax Court observed that the application of the aggregate approach or the entity approach was a function of the Congressional intent supporting the enactment
required only when the corporation electing S status directly holds the inventory which it accounted for under the LIFO method in its last year as a C corporation. It concluded that since CAC had never directly owned any inventories and never itself made an election to use the LIFO method, section 1363(d) was inapplicable. According to the court, unless there is some ambiguity in the language of a statute, a court's analysis must end with the statute's plain language. Therefore, under the

of the each of the non-subchapter K provisions involved in these respective cases. Coggin Auto. Corp., 115 T.C. at 365.

99Harris v. Garner, 216 F.3d 970, 976 (11th Cir. 2000) (en banc) ("When the import of the words Congress has used is clear . . . we need not resort to legislative history, and we certainly should not do so to undermine the plain meaning of the statutory language."); United States v. Morison, 844 F.2d 1057, 1064 (4th Cir. 1988) ("[W]hen the terms of a statute are clear, its language is conclusive and courts are 'not free to replace . . . (that clear language) with an unenacted legislative intent'."); Caminetti v. United States, 242 U.S. 470, 485 (1917) ("Where the language is plain and admits of no more than one meaning the duty of interpretation does not arise . . . ").

The Eleventh Circuit also observed that in Gitlitz v. Commissioner, 531 U.S. 206, 220 (2001), a case dealing with a potential double windfall to S corporation shareholders, the Supreme Court held that "[b]ecause the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." Coggin Auto. Corp., 292 F.3d 1326, 1332 (11th Cir. 2002). Furthermore, "[t]he result is required by statute." Id. (quoting Gitlitz, 531 U.S. at 220 n.10). If "this is an inequity in the United States Tax Code . . . only Congress or the Secretary (as the holder of delegated authority from Congress) has the authority to ameliorate" it. Id. (Congress did in fact reverse the result in Gitlitz by amending section 108(d)(7)(A) as part of The Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 147, 116 Stat. 21.)

The Eleventh Circuit also cited the appellate decisions of other circuits in support. See Hillman v. Commissioner, 250 F.3d 228, 234 (4th Cir. 2001), rev’g 114 T.C. 103 (2000); Brown Group, Inc. v. Commissioner, 77 F.3d 217, 222 (8th Cir. 1996), rev’g 102 T.C. 616 (1994) (the Eighth Circuit reversed the Tax Court’s use of the aggregate concept of partnership taxation to close what it perceived to be a loophole and held that “such a tax loophole is not ours to close but must rather be closed or cured by Congress”); Petroleum Corp. of Texas v. United States, 939 F.2d 1165, 1168 (5th Cir. 1991), rev’g 71A AFTR 2d 93-3772 (N.D. Tex. 1990).

In Petroleum Corp., the issue presented was whether a corporate partner in a partnership was subject to depreciation and depletion recapture under
"plain meaning" of the section 1363(d), the LIFO reserves built into the inventories held by the limited partnerships were not subject to recapture.

The [T]ax [C]ourt, while paying lip service to the "statutory scheme of 1363(d)," relies entirely upon the legislative history of Section 1363(d) and the line of cases using the aggregate approach, to provide an interpretation favorable to the Commissioner in sections 1245, 1250, and 1254 upon the liquidating distribution of interests it held in three partnerships. The Commissioner argued that although the transactions were motivated by a valid business purpose, the aggregate theory of partnerships must be applied to protect the integrity of the recapture provisions. The Fifth Circuit rejected this position. It found that the language of the statute was unambiguous, that under the statute partnership interests were not among the specific properties listed as being subject to recapture upon distribution, and that the aggregate theory could not be used to circumvent the clear language of the Code.

There [is no] Code authority extant that would have authorized ignoring or "looking through" the partnership to conclude, fictitiously, that the corporations were distributing assets then held in partnership solution as distinguished from distributing interests in the partnerships themselves. Federal income tax law is replete with examples of applying the entity theory of partnerships on some occasions while applying the conduit or aggregate theory on others. It suffices that there is no authority for the government's expedient position that use of the conduit theory is authorized and that such use should somehow override the clear language of the Code.

Petroleum Corp., 939 F.2d at 1168-69. In Petroleum Corp., the Fifth Circuit distinguished Holiday Village, supra note 98, on the ground that in that case the application of substance-over-form principles was appropriate because the taxpayer had no legitimate business purpose.

Note that on several other occasions, the Supreme Court has held that the touchstone of interpretation is legislative intent. See, e.g., Public Citizen v. United States Dept. of Justice, 491 U.S. 440, 452-54 (1989); Commissioner v. Engle, 464 U.S. 206, 214 (1984) ("sole task" of court in statutory interpretation is to determine Congressional intent); Philbrook v. Glodgett, 421 U.S. 707, 713 (1975) (court's objective in construing a statute is to ascertain the Congressional intent and give effect to the legislative will); Marcus v. Hess, 317 U.S. 537, 542 (1943); United States v. N.E. Rosenblum Truck Lines, Inc., 315 U.S. 50, 53 (1942) ("The question here, as in any problem of statutory construction, is the intention of the enacting body."); United States v. American Trucking Ass'n, 310 U.S. 534, 542 (1940) ("In the interpretation of statutes, the function of the courts is easily stated. It is to construe the language so as to give effect to the intent of Congress.").
quantum leap fashion. It is unclear from the opinion exactly how the [T]ax [C]ourt concluded that Congress intended this result.¹⁰⁰

Under the Eleventh Circuit’s holding, it would appear that section 1363(d) could be avoided with relative impunity.¹⁰¹ Where

¹⁰⁰Coggin Auto. Corp. v. Commissioner, 292 F.3d 1326, 1331 (11th Cir. 2002). The Court of Appeals also complained that the Tax Court's resort to the aggregate view of partnerships created an unacceptable level of uncertainty: “[i]t is worrisome to think that a taxpayer may not know in advance whether this would be the day that the fictional aggregate theory or the fictional entity theory of partnerships will be applied on an ad hoc basis.” Id. at 1333.

¹⁰¹The significance of the Eleventh Circuit’s decision to LIFO-method C corporations contemplating an S election is unclear. First, the recently finalized anti-Coggin Automotive regulations, if valid, extend the application of section 1363(d) to LIFO inventories held by partnerships in which the electing C corporation holds an interest. Second, it is clear from the issuance of these regulations that the Commissioner does not intend to acquiesce to the Eleventh Circuit’s decision and, under the Golsen rule, the Tax Court is not bound by the Eleventh Circuit's decision outside the jurisdiction of the Eleventh Circuit. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff’d on another issue, 445 F.2d 985 (10th Cir. 1971).

Third, CAC was vulnerable under several alternative arguments that were not pursued at trial or on appeal by the Government in Coggin Automotive: the tax benefit doctrine, the clear reflection of income doctrine, the assignment of income doctrine, and the step-transaction doctrine. See James P. Dawson & David W. LaRue, Eluding the LIFO Recapture Provisions of Subchapter S After the Eleventh Circuit’s Decision in Coggin Automotive: Part II, 5 BUSINESS ENTITIES 22, 22-26 (Sept. 2003). Apparently, these alternative arguments were not raised because the Service believed that its application of the aggregate concept to the Coggin Automotive limited partnerships was sufficient. If a fact pattern similar to that before the courts in Coggin Automotive arises, the Service can be expected to raise all of the arguments at its disposal. See ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000); Andantech v. Commissioner, 83 T.C.M. (CCH) 1476, 2002 T.C.M. (RIA) ¶ 2002-097.

Finally, the Treasury Department has since promulgated the so-called anti-abuse regulations under section 701. Reg. § 1.701-2. At trial and on appeal the Government stated that it was not asserting the anti-abuse regulations. Those regulations did not become effective until after the 1993 restructuring in Coggin Automotive had been consummated. The Commissioner will not be precluded from arguing the application of these regulations for taxpayers initiating Coggin Automotive-like transactions after their effective date.

These anti-abuse regulations are designed to prevent taxpayers from using the partnership tax rules of Subchapter K for tax avoidance purposes by empowering the Commissioner to disregard or recast transactions engaged in by
the LIFO inventory is already held by the subsidiary or subsidiaries of a C corporation, the corporation could simply replicate the restructuring plan effected by the taxpayer in Coggin Automotive. Where the LIFO inventory is held directly by the C corporation for which an S election is to be made, that corporation might transfer its LIFO inventory to a new or existing subsidiary partnership or LLC sometime prior to and in anticipation of making an S election.\(^{102}\) Alternatively, the

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an entity taxable under Subchapter K if to do so would prevent tax avoidance. In effect, the Commissioner has broad authority to modify the operation and interpretation of any statutory provision or regulation relevant to partnership taxation in order to prevent tax avoidance. The anti-abuse rule is made up of two components:

1. **Intent of Subchapter K rule.** The Commissioner is empowered to recast a transaction that reduces partners' aggregate tax liability in a manner that is "inconsistent with the intent of Subchapter K." The regulations describe the legislative intent for the partnership tax rules and set forth certain tests a partnership transaction must satisfy to be consistent with that intent. If the transaction is inconsistent, the Commissioner may disregard the partnership, disregard a taxpayer's status as a partner, adjust the partnership's or partner's accounting method, reallocate partnership income or loss, or otherwise change the claimed tax treatment.

2. **Abuse of entity rule.** The Commissioner is empowered to treat a partnership as an aggregate of its partners, rather than as a separate entity, to the extent necessary to carry out the purpose of any provision of the Code or regulations. This treatment may apply regardless of the taxpayer's intent in structuring the transaction. This rule may not be applied, however, where a provision of the Code or regulations prescribes entity treatment and contemplates the ultimate tax consequences resulting from that treatment.

\(^{102}\)Note, however, that the Eleventh Circuit expressly observed that CAC had never itself held any LIFO inventory:

Under its plain language, Section 1363(d) will apply and recapture of LIFO benefits will be triggered if two conditions are met: (1) a C corporation elects S corporation status under Section 1363(a); and (2) the C corporation "inventoried goods under the LIFO method" in the "last taxable year before the first taxable year for which the election under Section 1362(a) was effective."

Here it is clear that the first prong is met. However, it is apparent that, by definition, the second prong is not met. Coggin
corporation’s shareholders might transfer their stock to a new C
corporation holding company in a nontaxable section 351 exchange
and then replicate the Coggin Automotive restructuring plan. So
long as the taxpayer can garnish these pre-election maneuvers
with a sufficiency of business purpose, LIFO recapture, at least
in the Eleventh Circuit, might be avoided – a result that seems
clearly contrary to the legislative intent and one which would
essentially eviscerate section 1363(d).\(^{103}\)

never owned any inventories. Accordingly it never made an
election to use the LIFO method. In fact, the Commissioner
concedes in its brief that the plain language of Section 1363(d)
“does not literally apply to the facts of this case.”

Continuing on with the plain language of the statute, a C
corporation converting to S corporation status need only
recapture its “LIFO recapture amount.” Section 1363(d)(1). LIFO
recapture amount is defined as the difference between the value
of an inventory asset as it would have been valued using the FIFO
method and its value using the taxpayer's LIFO method. Section
1363(d)(3). An inventory asset is defined as the “stock in trade
of the corporation, or other property of a kind which would
properly be included in the inventory of the corporation if on
hand at the close of the taxable year.” Section 1363(d)(4)(B).

Here it is undisputed that Coggin held no stock in trade. Neither
did it hold property of a kind which would properly be included
in its inventory at the close of its taxable year. Therefore
under the plain meaning of the statute, there is no LIFO
recapture amount that can be attributed to Coggin.

Coggin Auto. Corp., 292 F.3d at 1331-32 (citations omitted).

\(^{103}\)Note, however, that the Eleventh Circuit is by no means alone in its
adherence to a statute’s plain meaning. See, e.g., supra note 99 (discussing
decisions of the Supreme Court and the Fourth, Fifth, and Eighth Circuits).
For an interesting discussion of several recent cases, including Coggin
Automotive, in which a decision of the Tax Court was overturned due to its
failure to apply the text of the statute being reviewed, see Brian Ladin,
The Plain Meaning Rule: Justice's Version of Tough Love, 104 Tax Notes (TA) 61
(July 5, 2004). See also John F. Manning, The Absurdity Doctrine, 116 Harv. L.
Rev. 2387 (2003); Peter H. Carroll, III, Literalism: The United States Supreme
Court's Methodology for Statutory Construction in Bankruptcy Cases, 25 St.
Mary’s L.J. 143 (1993); Edward Heath, How Federal Judges Use Legislative
History, 25 J. Legis. 95 (1999); Bradford L. Ferguson et al., Reexamining the
Nature and Role of Tax Legislative History in Light of the Changing Realities
of the Process, 67 Taxes 804 (1989); Michael Livingston, Congress, the Courts,
2. The New Regulations

In August 2004, the Treasury issued proposed regulations that would expressly require the application of the aggregate concept of partnership taxation to LIFO inventories held by any partnership in which a C corporation owns a “lookthrough partnership interest” at the time of its election to be taxed under Subchapter S (or at the time the C corporation transfers its assets to an S corporation in a nontaxable carryover-basis transaction).\(^{104}\) A “lookthrough partnership interest” is an interest in a partnership that owns LIFO inventory either directly or indirectly through one or more partnerships.\(^{105}\)

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\(^{104}\)The look-through approach taken by these regulations generally mirrors the approach taken by Regulation section 1.1374-4(i) in applying section 1374 to S corporations that hold interests in partnerships that dispose of built-in gain assets during the ten-year recognition period. Those regulations are designed to prevent the avoidance of section 1374 when built-in gain assets are disposed of by a partnership in which the S corporation owns an interest. Regulation section 1.1374-4(i) generally applies the aggregate approach to treat S corporation partners as direct owners of the assets held by their partnerships for the purpose of taxing the built-in gains recognized upon the sale of such assets by the partnership within the ten-year recognition period. But see infra notes 109 and 214.

The look-through approach taken by these regulations is also required in computing a C corporation’s adjustment to its “adjusted current earnings” for changes in the LIFO recapture amount of inventories held by a partnership in which the corporation owns an interest. Infra note 185.

\(^{105}\)Reg. § 1.1363-2(c)(3).
These proposed regulations, with only one substantive modification, were finalized by Treasury Decision 9210, 2005-33 I.R.B. 290, on July 11, 2005.\textsuperscript{106} Under the final regulations, section 1363(d) applies regardless of whether the LIFO inventory was transferred to a partnership in anticipation of an S election\textsuperscript{107} (or in anticipation of a nontaxable disposition of assets to an S corporation) or is held by a partnership in which the electing corporation owns a long-standing interest.\textsuperscript{108} They apply regardless of the corporation’s percentage of ownership in the partnership, regardless of the value or relative value of the LIFO inventory held by the partnership or the magnitude of the LIFO recapture amount,\textsuperscript{109} and irrespective of the presence or absence of a business purpose.\textsuperscript{110}

\textsuperscript{106}The final regulations are effective for S elections and transfers made on or after August 13, 2004. Reg. § 1.1363-2(g)(3).

\textsuperscript{107}This was the case with respect to four of the original CAC subsidiaries in Coggin Automotive. Coggin Auto. Corp., 115 T.C. at 352-53, 356-57 (2000).

\textsuperscript{108}This was the case with respect to the fifth CAC subsidiary in Coggin Automotive. Coggin Auto. Corp., 115 T.C. at 354, 357.

\textsuperscript{109}Unlike the section 1374 regulations, the section 1363(d) regulations do not provide a de minimis exception. See Reg. § 1.1363-2. Under Regulation section 1.1374-4(i)(5), 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 ten percent of the partnership capital and profits and has a fair market value of less than $100,000. This exception eliminates the potentially substantial burden of tracking built-in gain assets that are relatively small in value. Since section 1363(d) recapture occurs all at once, the Treasury believes that the relatively minimal burden of looking through the partnership to determine the corporation’s share of LIFO recapture amount does not warrant a de minimis exemption.

\textsuperscript{110}Regulation section 1.1363-2, in relevant part, reads:

Recapture of LIFO benefits.
3. **Validity of the Regulations**

In extending the reach of section 1363(d) to include both (1) dispositions of LIFO inventory by C corporations to S corporations in nontaxable carryover-basis transactions, and most recently, (2) indirect ownership of LIFO inventories through a partnership or through tiered partnerships, the regulations go well beyond the literal language of the statute. Not surprisingly, it has been suggested that the Treasury, in issuing the 1994 regulations, may have overstepped its statutory authority,\(^{111}\) a contention that is likely to be repeated in

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(b) LIFO inventory held indirectly through partnership. A C corporation must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(4) 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)(3) 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)).

connection with the new anti-Cogglin Automotive regulations. In the end, the type and degree of deference accorded these regulations by the courts in any judicial review of their
validity is likely to depend, in part, on whether these regulations are considered “legislative” or merely “interpretive.”¹¹²

Administrative law distinguishes the rules issued by governmental agencies as being either legislative or interpretive. Generally stated, a “legislative rule” is one that creates legally enforceable duties that did not exist prior to its promulgation.¹¹³ A legislative rule is valid only if the agency adopting it has congressional authority to do so and only if it has followed the notice and comment procedures required by the Administrative Procedure Act in adopting the regulation.¹¹⁴ If valid, legislative rules bind the issuing agency, the courts, and taxpayers.


¹¹³ Michael Asimow, Nonlegislative Rulemaking and Regulatory Reform, 1985 DUKE L.J. 381, 383 (1985) (“A legislative rule is essentially an administrative statute – an exercise of previously delegated power, new law that completes an incomplete legislative design. Legislative rules frequently prescribe, modify, or abolish duties, rights, or exemptions.”) (citation omitted).

By contrast, “interpretive rules” typically clarify the duties already imposed by statute, rather than creating new ones.\textsuperscript{115} Interpretive rules can be promulgated without following the notice and comment procedures,\textsuperscript{116} and, although they may bind taxpayers as a practical matter, they do not, as a legal matter necessarily bind either taxpayers or the courts.\textsuperscript{117}

In tax cases, the courts have tended to distinguish between legislative regulations and interpretive regulations based principally on the source from which the Treasury\textsuperscript{118} derives its authority to promulgate the regulation. Regulations promulgated for implementing these requirements, see 26 CFR Part 601 ("Statement of Procedural Rules").

\textsuperscript{115}For problems in distinguishing between “rule-making” and “interpretation,” see Michael Asimow, Public Participation in the Adoption of Interpretive Rules and Policy Statements, 75 MICH. L. REV. 521, 530-84 (1977).

\textsuperscript{116}5 U.S.C. § 553(b)(3)(A), (B).

\textsuperscript{117}See, e.g., Koshland v. Helvering, 298 U.S. 441, 446–47 (1936) (“Where the act uses ambiguous terms, or is of doubtful construction, a clarifying regulation or one indicating the method of its application to specific cases not only is permissible but is to be given great weight by the courts. And the same principle governs where the statute merely expresses a general rule and invests the Secretary of the Treasury with authority to promulgate regulations appropriate to its enforcement. But where . . . the provisions of the act are unambiguous, and its directions specific, there is no power to amend it by regulation.” (citation omitted)). See also, e.g., Caterpillar Tractor Co. v. United States, 589 F.2d 1040, 1045 (Ct. Cl. 1978); Nalle v. Commissioner, 99 T.C. 187 (1992). See also Boris I. Bittker and Lawrence Lokken, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS, ¶ 110.4.2 ("by contrast, interpretative regulations purport only to interpret, explain, and apply the rules prescribed by Congress, rather than to fill gaps deliberately left open by Congress, and this limited function leaves more room for judicial review to determine whether the agency's interpretation is a distortion of the legislation.").

\textsuperscript{118}The Assistant Secretary for Tax Policy, as delegate for the Secretary of the Treasury, is responsible for drafting tax regulations with the help of advisors in the Office of Tax Legislative Counsel. Initial drafting responsibility, however, has been delegated to the Commissioner of Internal Revenue with the help of the attorneys in the Office of Associate Chief Counsel (Technical).
under the general authority of section 7805(a) are generally considered “interpretive,” and regulations promulgated pursuant to a grant of authority under a particular Code section are considered “legislative.”

4. Source of Authority for Section 1363(d) Regulations

Although section 1363(d) was enacted as a backstop to section 1374, section 1363(d) does not itself contain provisions corresponding to either section 1374(d)(8), which extends application of the built-in gains tax to assets acquired by an S corporation from a C corporation in a nontaxable carryover-basis transaction, or section 1374(e), which expressly authorizes the Secretary of the Treasury to “prescribe such regulations as may be necessary to carry out the purposes [of section 1374].” The statutory authority for regulations expanding the scope of the application of section 1363(d) beyond that expressly provided in

\[\text{Footnotes:}\]

119 The Service takes the position that tax regulations are almost always interpretive and only rarely legislative, notwithstanding the fact that the Treasury generally follows the kind of procedures that the Administrative Procedure Act requires (i.e., notice to taxpayers and the opportunity to comment) only for legislative regulations. See also Asimow, supra note 113, at 390. Some notices of proposed rulemaking cite both section 7805(a) and a specific grant of authority.

120 Neither the Treasury nor the Service has suggested that Congress intended either of these sections to extend by implication to section 1363(d). See, for example, F.S.A. 1999-1120 (Oct. 4, 1993)1993 WL 1468128 quoted supra note 78.
the statutory language, therefore, rests either on the Secretary’s general rule-making authority under section 7805(a)\textsuperscript{121} or on section 337(d), which empowers the Secretary to prescribe regulations that are necessary or appropriate to effectuate the repeal of the General Utilities doctrine and to “ensure that [the new anti-General Utilities rules] may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of [Subchapter C]). . . .”\textsuperscript{122} Treasury Decision 8567,\textsuperscript{123} which promulgated the 1994 regulations, does not itself reveal the statutory basis upon which those regulations were issued, but the new anti-Coggin Automotive regulations expressly state that they derive their authority from section 337(d).\textsuperscript{124}

A literal reading of the statutory language does not authorize an extension of the authority granted to the Secretary under section 337(d) to section 1363(d). The anti-General

\textsuperscript{121}Section 7805(a) reads as follows:

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

\textsuperscript{122}I.R.C. § 337(d)(1). Part III of Subchapter C includes sections 351 through 368 (taxation of corporate organizations, divisions, and reorganizations).

Utilities rules to which the scope language of section 337(d) refers are those found in “the amendments made by subtitle D of title VI of the Tax Reform Act of 1986” (which included pre-1986 Tax Reform Act sections 336, 337, and 1374). Since section 1363(d) was not enacted until 1987 and is not included in the list of sections referred to in section 337(d), both the 1994 and the 2005 regulations may be vulnerable to attack.

Nevertheless, the legislative purpose of section 1363(d) (i.e., to further effectuate the repeal of General Utilities in the special case of LIFO-method C corporations electing S status) arguably justifies the extension of the broad authority granted to the Secretary under section 337(d) to section 1363(d). Furthermore, as previously noted, failure to extend the scope of section 1363(d) could have the absurd effect of nullifying section 1363(d).


126 See supra note 6.

127 It seems well established that any construction of a statutory provision that would render the provision completely ineffective must be presumed to be invalid. This is especially true where a reasonable alternative construction would be effective in carrying out legislative intent:

Where the language and purpose of the questioned statute is clear, courts, of course, follow the legislative direction in interpretation. Where the words are ambiguous, the judiciary may properly use the legislative history to reach a
IV. THE “LIFO RECAPTURE AMOUNT”

A. In General

The amount of gross income that the “converting corporation”¹²⁸ is required to recognize under section 1363(d)(1) (“the section 1363(d) inclusion”) on its tax return for the “recognition year” is the “LIFO recapture amount” (LRA) that is built into the LIFO inventories that the converting corporation

¹²⁸As used throughout this Article, the term “converting corporation” refers to the corporation that will be required to recognize the LIFO recapture amount on its income tax return. This will usually be the C corporation that elects to be taxed under Subchapter S or the transferor C corporation that transfers its assets to an S corporation in a nontaxable carryover-basis transaction. However, where (1) the LIFO inventory is transferred by a C corporation to a new subsidiary corporation in a nontaxable corporate division (under sections 368(a)(1)(D) and 355), and (2) an S election is made for the transferee-distributed corporation that takes effect immediately, the converting corporation will be the transferor-distributing corporation.


It is obvious, of course, that if we were to read Section 14(b) literally, the states would only have the power to prohibit agreements which require “membership” in a union as a condition of employment. But, as the Supreme Court has indicated on numerous occasions, we need not be bound by the strict letter of a statute if, by doing so, we would defeat the congressional purpose or create an absurd result . . . . It is our purpose to demonstrate that a literal construction of Section 14(b) would frustrate the very purpose for which it was enacted and would create a patently absurd result.
holds either directly, or, under the regulations, indirectly through one or more partnerships, on the “recapture date.”\textsuperscript{129} The LRA is the excess, if any, of the inventory’s value determined under the FIFO method\textsuperscript{130} over its actual LIFO value. Stated

\textsuperscript{129}Where the converting corporation’s S election triggers section 1363(d), the LRA is determined as of the close of the recapture date. When the transfer of a C corporation’s assets to an S corporation in a nontaxable carryover-basis transaction triggers section 1363(d), the LRA is determined as of the moment before the transfer occurs. Reg. § 1.1363-2(c)(2).

\textsuperscript{130}For this purpose, the FIFO value of the inventory is generally determined by using the “retail method” if the corporation uses the retail LIFO method in computing its regular taxable income, or by using the “lower-of-cost-or-market” method (LCM) if it does not. I.R.C. § 1363(d)(4)(C); Reg. § 1.1363-2(c)(4)(i).

Under the retail method, the taxpayer’s tax basis in its ending inventory is determined by multiplying the retail value of that ending inventory by the “cost complement.” Simply stated and subject to considerable refinement, the cost complement is the ratio of the current cost of the goods to their retail selling prices. Under this method, ending inventory can be determined either at cost (where the cost complement is computed by adjusting the initial retail sales prices of these goods by subsequent net “markups” and net “markdowns”) or at lower-of-cost-or-market (by ignoring net markdowns in computing the cost complement).

The retail FIFO and retail LIFO methods are practical adaptations of the traditional cost-based methods. They are designed to meet the special needs and circumstances that are unique to high-volume retailers that customarily deal in a wide variety of low-unit-value merchandise. The retail methods allow retail stores to develop reasonably accurate monthly profit-and-loss statements without having to take physical inventories and without having to determine and record the cost of each item sold in the perpetual records. They also greatly simplify the process of taking physical inventories and booking the results.

Under LCM, the taxpayer compares the cost of each article in its ending inventory to the “market” price of that item. If the cost exceeds market, then the FIFO cost of that item is written down to market. Except in the case of certain “abnormal” or “subnormal” goods, “market” is not the estimated “net realizable value” (i.e., expected sales price less direct selling costs) of an inventory item, as the name suggests, but rather the replacement cost of that item as of the inventory date. For retailers and wholesalers, market will be the inventory-date cost of replacing the item plus the amount of any additional costs required to be capitalized to their inventories under the uniform capitalization rules of section 263A. Manufacturers and processors will apply LCM to their work in process and finished goods inventories, and the basic elements of cost will include the inventory-date cost of direct materials, direct labor, and any indirect costs required to be included in costing inventories under section 263A.
differently, the LRA is the cumulative net amount of gross income that the converting corporation has deferred using LIFO, rather than FIFO, since its adoption of LIFO.\textsuperscript{131}

As used throughout the remainder of this Article, the term “recognition year” is the tax year in which this income is recognized, which is generally the converting corporation’s last tax year as a C corporation or, in the case of certain nontaxable carryover-basis transactions, its last tax year ending with its complete liquidation.\textsuperscript{132} The “recapture date” is generally the last day of the recognition year.\textsuperscript{133} However, where

There is no explicit authorization for LCM in the statute. Instead, the method is permissible on the authority of Regulation section 1.471-2(c), which concludes that LCM meets the statutory requirements of section 471(a) (i.e., that it conforms with industry practice and that it clearly reflects income). The LCM methodology applicable to normal goods under normal circumstances is described in Regulation section 1.471-4(a), (c). For the application of LCM to abnormal goods and subnormal goods, see Regulation sections 1.471-4(b) and 1.471-2(c), respectively.

\textsuperscript{131}See, e.g., supra Figure 1d text following note 48.

\textsuperscript{132}Where a C corporation transfers its assets to an S corporation in a nontaxable Type A or Type C reorganization, in an acquisitive Type D or Type G reorganization, or in a section 332 liquidation, the transferor corporation’s tax year closes as of the date of the transfer. I.R.C. § 381(b)(1) and (2). (The transferor corporation’s tax year does not close, however, where the transfer is incident to a Type F reorganization. I.R.C. § 381(b).)

\textsuperscript{133}Regulation section 1.1363-2(c)(1) reads:

(1) \textit{Recapture date}. In the case of a transaction described in paragraph (a)(1) or (b)(1) of this section [i.e., S election by a C corporation that holds LIFO inventory or a lookthrough partnership interest], the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (a)(2) or (b)(2) of this section [i.e., transfer of LIFO inventory or a lookthrough partnership interest by a C corporation to an S corporation in a nontaxable carryover-basis transaction], the recapture date is the date of the transfer of the [LIFO inventory or the lookthrough] partnership interest to the S corporation.
(1) the LIFO inventory is transferred by a C corporation to a new subsidiary incident to a nontaxable section 368(a)(1)(D), and 355 corporate division (under sections 368(a)(1)(D) and 355), and (2) an S election is made for the transferee-distributed corporation that takes effect immediately as of the date of its formation, the recapture date is the date that the inventory is transferred to the new subsidiary and the recognition year is the tax year of the transferor-distributing C corporation in which the transfer and distribution occur.\footnote{The transferor-distributor corporation’s tax year does not close on the date of the transfer in a section 368(a)(1)(D) and 355 divisive reorganization. See I.R.C. § 381(a), (b) (corporate divisions are not among the transactions subject to section 381).}

Additionally, the regulations provide for a special recapture date for LIFO inventory held by the converting corporation indirectly through a partnership where certain conditions are satisfied.\footnote{See infra Part IV.C.2. (“Recapture Date for Determining Lookthrough LRA”).}

1. Calculating the LRA for Alternative Minimum Tax Purposes

Section 1363(d) triggers the recognition of income for both regular tax purposes and alternative minimum tax (AMT)
purposes.\textsuperscript{136} Regarding the latter, the converting corporation’s LRA will be a factor in computing its “pre-adjustment alternative minimum taxable income” (pre-adjustment AMTI)\textsuperscript{137} and its “adjusted current earnings” (ACE) for the recognition year. The converting corporation’s “earnings and profits” (E&P) account may also be affected.\textsuperscript{138}

For federal income tax purposes, the same LIFO inventory can have as many as four different LRAs. Although the LRA is always calculated by subtracting the LIFO value of the inventory from its FIFO value (and it can never be negative), the amounts of some of the costs capitalized to an inventory (to establish its respective LIFO and FIFO values) are determined under

\textsuperscript{136}Many C corporations are exempt from the AMT under the “small corporation exemption” of section 55(e). For tax years beginning after December 31, 1997, the “tentative minimum tax” of a corporation is zero for any taxable year if the corporation's average annual gross receipts for all three-tax-year periods beginning after December 31, 1993 and ending before the taxable year in question have never exceeded $7.5 million. I.R.C. § 55(e)(1)(A). The gross-receipts test is applied by substituting $5 million for $7.5 million for the first three-tax-year period of the corporation that is taken into account in determining whether or not the corporation qualifies for this exemption. I.R.C. § 55(e)(1)(B). The gross-receipts test is applied by taking into account the gross receipts of certain other related corporations and of certain predecessor corporations. I.R.C. §§ 55(e)(1)(D), 48(c)(2), (3). If a corporation loses its exemption, the exemption is lost for all future years. S. Rep. No. 105-174, at 153 (1998). With important exceptions, a corporation’s tentative minimum tax for its first tax year is zero. I.R.C. § 55(e)(1)(C).

In the author’s opinion, the section 1363(d) inclusion would not be taken into account in determining the corporation’s gross receipts for this or any other purpose: the section 1363(d) inclusion is not a “receipt” and section 1363(d)(1), by its own terms, only requires that the LRA be included in “gross income.”

\textsuperscript{137}“Pre-adjustment AMTI” is AMTI without regard to adjustments for “adjusted current earnings” or the alternative tax net operating loss deduction. Reg. § 1.56(g)-1(n)(3).
different rules for different purposes. For example, under section 263A, depreciation on production equipment and facilities must generally be capitalized to the cost of goods produced during the taxable year, the unsold portion of which winds up in ending inventory. The permissible methods for determining the amount of depreciation for regular taxable income purposes generally differ from those that are required for use in computing pre-adjustment AMTI, which generally differ from those required to be used in computing a C corporation’s ACE, and which generally differ from those required in computing a C corporation’s E&P.

138 See infra Part IV.A.2. (“Adjustment to E&P”).
139 See, e.g., I.R.C. §§ 167, 168(b), (g).
140 See I.R.C. § 56(a)(1).
141 See I.R.C. § 56(g)(4)(A); Reg. § 1.56(g)-1(f)(3)(iii)(D) (effective for taxable years beginning after December 18, 1992, unless the taxpayer elected to apply these rules to all taxable years beginning after December 31, 1989). (Notice 94-27 provided rules governing the computation of the LIFO recapture adjustment to ACE for tax years beginning after 1989 and before 1992 for corporations that did not choose to apply Regulation section 1.56(g)-1(f)(3) to those years. 1994-1 C.B. 343. This Notice also provided a transition rule for those corporations.)
142 See I.R.C. § 312(k). This unfortunate and confusing state of affairs has not escaped the notice of commentators. See, e.g., Stewart S. Karlinsky, A Report on Reforming the Alternative Minimum Tax System, 12 AM. J. TAX. POL’Y 139, 139-40 (1995):

The issues of complexity and administrability that are encountered under the regular tax system are exacerbated by the parallel world concept that is a feature of the corporate AMT. . . . Taxpayers experience significant difficulty in dealing with the regular tax system, which has its unique definitions, interrelated Code sections, computations, and planning requirements. They experience even more difficulty in dealing with these features a second time in computing the AMT. [Corporate] taxpayers are then required to deal with these complexities a third time . . . to compute the adjusted current earnings . . . adjustments . . . . The AMT requires that tax
To the extent that the converting corporation’s LIFO inventory is treated as having been produced or acquired during taxable years beginning after December 31, 1989, the inventory amounts used in computing LIFO and FIFO values for the purposes of determining its pre-adjustment AMTI and its ACE must take into account the adjustments and tax preferences set forth in sections 56 through 58.\textsuperscript{143} However, an election is available that allows taxpayers to use their regular tax inventory values in calculating pre-adjustment AMTI and ACE.\textsuperscript{144} Where the converting corporation has previously made this election, the LRA used in

\textsuperscript{143}Reg. § 1.56(g)-1(f)(3)(iii)(D).

\textsuperscript{144}Reg. § 1.56(g)-1(r). To avoid the complexity and recordkeeping burden that generally results from computing and tracking inventory values separately for each of these purposes, the regulations permit taxpayers to elect to compute its AMT adjustments and preferences for the year without regard to the portions of these adjustments and preferences that would otherwise have to be capitalized in ending inventory. \textit{Id}. Although this election will typically have the effect of accelerating the recognition of AMTI, the upside is that the taxpayer can use the same inventory values and cost of goods sold values that it computed for regular tax purposes in making all of its AMT calculations.
computing its regular and alternative minimum taxes will be the same.\textsuperscript{145}

The effect that the recognition of the LRA will have on the converting corporation’s AMT liability and on its utilization of any AMT credit carryforwards is discussed and illustrated later in this Article.\textsuperscript{146}

2. Adjustment to E&P

The income recognized under section 1363(d) will generally have little or no effect on the converting corporation’s E&P. For taxable years beginning after September 30, 1984, LIFO-method C corporations have been effectively required to determine their E&P using the FIFO method. Section 312(n)(4) requires that the E&P of a LIFO-method C corporation be adjusted

\textsuperscript{145}This is true even if the election was made subsequent to the corporation’s adoption and use of LIFO. The election purges the taxpayer’s opening inventory of any differences between the pre-election and post-election inventory values by requiring that these differences be recognized as additions to the corporation’s pre-adjustment AMTI and ACE. Regulation section 1.56(g)-1(r)(3)(i) generally requires that this election be made retroactively to the earliest open tax year. The restatement of the corporation’s opening inventory for that year is a change in an accounting method that will give rise to a section 481(a) adjustment. The corporation must also recompute its inventory values, and its AMT liability, for that year and all subsequent prior years. Any additional taxes that result from these restatements must be paid on amended returns. Reg. § 1.56(g)-1(r)(3)(ii).

\textsuperscript{146}See infra Part V.B. (“Alternative Minimum Tax”).
annually to reflect changes in its LRA.\footnote{147} Consequently, unless the converting corporation adopted LIFO prior to the effective date of section 312(n)(4), its E&P will have already been increased by the LRA recognized under section 1363(d).\footnote{148} The effect on E&P of the installment payments of the incremental taxes resulting from the application of section 1363(d) is discussed below in Part VII.\footnote{149}

B. **Negative LIFO Reserve**

1. **General**

Although it is possible for a taxpayer to have a negative LIFO reserve (i.e., LIFO value exceeds FIFO value), the LRA cannot be negative.\footnote{150} Thus, in the relatively unusual case where the converting corporation’s LIFO value exceeds its FIFO

\begin{itemize}
\item \footnote{147}Unlike the adjustments required in computing ACE (see infra Part V.B.2. ("LRA Adjustment to ACE")), negative adjustments are not permitted to reduce E&P below the LRA that was built into the opening inventory for the corporation’s first taxable year beginning after the effective date of this provision (Sept. 30, 1984).
\item \footnote{148}Note, however, that if the LIFO and FIFO values used in computing the LRA for E&P purposes differ from those used in computing the LRA for regular tax purposes (see supra Part IV.A.1. ("Calculating the LRA for Alternative Minimum Tax Purposes")), then an adjustment to E&P may be required to reconcile those differences.
\item \footnote{149}See also infra Part VII.B. ("Adjustments for the Incremental Tax Imposed on the Section 1363(d) Inclusion").
\item \footnote{150}I.R.C. § 1363(d)(3). See also Rev. Proc. 94-61, Q&A No. 4, 1994-2 C.B. 775.
\end{itemize}
value,\textsuperscript{151} the LRA is zero and the converting corporation is not permitted to recognize and deduct a negative LIFO reserve in computing its gross income for the recognition year.

This asymmetry is difficult to reconcile with the stated purpose of section 1363(d) (i.e., “[t]o eliminate [the] potential disparity in treatment [between LIFO and FIFO taxpayers]”).\textsuperscript{152} A negative LIFO reserve is an amount that a FIFO-method C corporation would have previously recognized in computing its cost of goods sold and deducted against its gross revenues in computing its taxable income and its corporate tax liability. Conversely, a negative LIFO reserve is unlikely ever

\textsuperscript{151}Unusual in that where this situation exists, i.e., where replacement costs for a particular inventory item (under specific-goods LIFO) or for the items in a pool of inventory (under dollar-value LIFO) are declining (as has generally been the case with, for example, computer hardware and televisions), most taxpayers would have adopted, or would have changed to, the FIFO method so that the older, higher inventory costs could be deducted sooner in computing cost of goods sold.

If the corporation anticipates continuing annual deficits in its LIFO reserve, it should consider discontinuing its use of the LIFO method. A change from LIFO to FIFO could give rise to a negative section 481(a) adjustment, all of which would be recognized in the year of the change. Rev. Proc. 2002-19, 2002-1 C.B. 696, amplified by Rev. Proc. 2002-54, 2002-2 C.B. 432. The LIFO election is generally irrevocable – once adopted, it must be used in all later taxable years unless the Commissioner requires another method to be used or authorizes a change pursuant to a written request by the taxpayer to discontinue LIFO. Revenue Procedure 2002-9, appendix § 10.01, 2002-1 C.B. 327, however, allows certain taxpayers to obtain automatic consent to discontinue the use of LIFO if they comply with certain specified terms and conditions.

Taxpayers who have previously changed from LIFO to FIFO are not permitted to re-elect LIFO for a period of at least five taxable years, beginning with the year of the change, unless, based on a showing of unusual and compelling circumstances, consent is specifically granted by the Service. The request for permission to readopt LIFO must comply with the terms and procedures set forth in Revenue Procedure 97-27, 1997-2 C.B. 97. Rev. Proc. 2002-9, app. § 10.01(2), 2002-1 C.B. 327.

to produce any savings of corporate-level taxes. 153 In the opinion of the author, section 1363(d), if not repealed, 154

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153 This is true for two reasons. First, only the portion of the negative LIFO reserve that represents an unrealized built-in loss can even potentially generate corporate-level tax savings. A negative LIFO reserve is the excess of the inventory’s LIFO value over its FIFO value, whereas an unrealized built-in loss, if any, is the excess of the inventory’s LIFO value over its “fair market value” (as defined in Regulation section 1.1374-7). See infra Part IV.E. (“Excess Built-in Gain May Be Subject to Section 1374”).

For example, inventory that has a LIFO value of $100, FIFO value of $70, and a fair market value of $90, has a negative LIFO reserve of $30, but an unrealized built-in loss of only $10. Although the statute provides special ameliorative rules for the $10 unrealized built-in loss, it provides no mechanism that would otherwise enable the converted corporation to use the remaining $20 negative reserve to generate corporate-level tax savings. See e.g. Reg. § 1.1374-4(b)(2), -4(b)(3), Ex. (1).

Second, the ultimate utilization of the unrealized losses built into the value of the converting C corporation’s LIFO inventory to produce savings in corporate-level taxes is far from assured. Savings of taxes otherwise imposed under section 1374 can result from (i) the negative effect that the unrealized loss built into that inventory has on the amount of the corporation’s “net unrealized built-in gain” (which sets the upper limit on the cumulative amount of net recognized built-in gains that are subject to section 1374), and/or from (ii) the eventual recognition of part or all of this loss within the ten-year recognition period (but only if and to the extent that the converted corporation has “recognized built-in gains” in that same year), or from both. See supra note 15. The converted corporation will recognize the losses built into the value of its recapture-date LIFO inventory layer only if and to the extent that it experiences a decrement in that layer. (Note that the inventory method used by the converted corporation for tax purposes must generally be used to identify whether the inventory it disposes of during the ten-year recognition period is inventory it held as of the first day of that period. See infra note 177.)

If a converting corporation changed from LIFO to FIFO at a time when it had a negative LIFO reserve and if the change was effective for the recognition year (or for a tax year preceding the recognition year), then the negative section 481 adjustment amount would have offset income otherwise subject to corporate-level taxes in that year, or it would have increased the converting corporation’s net operating loss carryover from that year, or both. Conversely, if the LIFO-to-FIFO change is made after the corporation’s conversion, the entire negative LIFO reserve will be recognized as a section 481 adjustment in the year of change (and pass through to the S corporation’s shareholders), but only the built-in loss component of that reserve ($10 in the above example), if any, will be taken into account in determining the corporation’s section 1374 net recognized built-in gain for the year. (Note, however, that if a corporation changes its method of accounting for inventory with a principal purpose of avoiding the tax imposed under section 1374, it must use its former method to identify its dispositions of inventory. Reg. § 1.1374-7(b); see infra note and 232.)

154 See infra Part VIII (“CONCLUSION”).
should be revised to permit a converting corporation to reflect a negative LRA in the computation of its gross income for the recognition year.\textsuperscript{155}

2. Multiple LIFO Inventories

What happens when a converting corporation holds multiple LIFO inventories, has multiple pools in its dollar-value LIFO inventories, or owns a lookthrough partnership interest in two or more LIFO-method partnerships,\textsuperscript{156} and the LIFO reserve of some of these inventories are positive and others are negative? Neither section 1363(d) nor the regulations thereunder provide any definitive guidance as to whether the LRA is to be computed on an inventory-by-inventory basis, with only positive LIFO reserves being included in the computation of the LRA, or by taking into account all of the corporation’s LIFO inventories to derive a net LRA.

\textsuperscript{155}This asymmetry also exists, and is equally difficult to justify, in the statutory rules requiring adjustments to E&P and to ACE for changes in a C corporation’s LRA. Section 312(n)(4) and section 56(g)(4)(D)(iii) do not permit the recognition of a negative LIFO reserve.

\textsuperscript{156}Manufacturers, wholesalers, and retailers typically maintain several discrete LIFO inventories. Where the taxpayer uses the specific-goods LIFO method, it must maintain a separate LIFO inventory for each type of inventory. Where the taxpayer instead uses the dollar-value method of accounting for its LIFO inventory, it may combine similar lines, types, or classes of goods into inventory pools and account for the various items in each pool as a single inventory. See supra, Part II.B.2. ("Dollar-value
This issue has, however, been addressed in the regulations that deal with the LRA adjustments that are required to be made in computing a C corporation’s ACE under the alternative minimum tax. Although these regulations do not override the statute’s prohibition against adjustments for negative LIFO reserves,\textsuperscript{157} they do provide that a corporation “computes a single [LRA] for all of its assets that are accounted for under LIFO,” rather than computing “a separate [LRA] for each grouping or pool of LIFO inventory.”\textsuperscript{158}

In the opinion of the author, the amount recognized under section 1363(d) should be the net LRA that combines the positive and negative LIFO reserves of all of the converting corporation’s LIFO inventories, including the LIFO inventory that it is deemed to hold indirectly through a partnership,\textsuperscript{159} that are taken into account in computing the converting corporation’s taxable income for the recognition year. This approach produces a more rational and equitable result, and it

\textsuperscript{157}I.R.C. § 312(n)(4)(B); Reg. § 1.56(g)-1(f)(3)(iii)(A).

\textsuperscript{158}Preamble, T.D. 8454, 1993-1 C.B. 5 (“The final regulations clarify that a taxpayer (i.e., a corporation) computes a single LIFO recapture amount for all of its assets that are accounted for under LIFO”).

\textsuperscript{159}This approach is supported by the fact that in a number of different contexts, including the regulations under section 1363(d) (discussed infra Part IV.C. (“LIFO Inventory Held Indirectly Through a Partnership”)), a partner is treated as if it directly owned its proportionate shares of partnership assets for purposes of applying various provisions of the Code.
finds support both in the language of section 1363(d)(3), the ACE regulations that deal with this issue in an analogous situation, and, albeit tangentially, in the approach taken by outside of Subchapter K. See discussion of the aggregate concept. See supra note 98.

160 First, section 1363(d)(1) refers to “the LIFO recapture amount” (emphasis added), rather than to the sum of multiple LRAs.

Second, section 1363(d)(3), which defines “LIFO recapture amount,” can be read as referring to all of the LIFO inventory assets held by the converting C corporation:

(3) LIFO recapture amount. For purposes of this subsection, the term “LIFO recapture amount” means the amount (if any) by which —

(A) the inventory amount of the inventory asset under the first-in, first-out method authorized by section 471, exceeds

(B) the inventory amount of such assets under the LIFO method. (emphasis added).

The use of singular terms (“the amount” and “the inventory amount”) rather than plural terms here supports the conclusion that each corporation using LIFO has a single LIFO recapture amount. Moreover, the inventory amount referred to in subparagraph (B) of this definition relates to “the inventory assets” of the corporation, with the implication that the reference is to all of the inventory assets of the corporation. Although the use of the singular “asset” in paragraph (A) might be interpreted to require an asset-by-asset or inventory-by-inventory approach to the calculation of the LRA (with only positive amounts being considered), this view is contradicted both by the plural use of “assets” in paragraph (B) and by the wording of the definition of “LIFO recapture amount” under section 312(n)(4)(B) and Regulation 1.56(g)-1(f)(3)(iii)(A), which is identical to the section 1363(d)(3) definition except that section 312(n)(4)(B) uses the plural “assets” consistently. The author can find nothing in the legislative history or purpose of section 1363(d) that would suggest that the singular use of “asset” in the above quoted language is anything other than a drafting error or a mildly unfortunate choice of words.

161 See Leslie J. Schneider & Patrick J. Smith, Attorneys Comment on the Amount of LIPO Adjustments, 92 Tax Notes (TA) 181 (Sept. 4, 1992), where the authors presented several arguments to support their contention that any corporation subject to section 56(g)(4)(D)(iii) should have a single LRA for all of the LIFO inventories that it holds directly and indirectly through partnerships and LLCs. The final regulations subsequently adopted the single, net LRA approach. See supra note 158.
section 1374 of limiting that section’s application to net unrealized built-in gains and net recognized built-in gains.162

C. LIFO Inventory Held Indirectly Through a Partnership

Under the new anti-Coggin Automotive regulations, a converting corporation that holds LIFO inventory indirectly through an interest in one or more partnerships is required to include the “lookthrough LRA” in its gross income for the tax year that includes the recapture date.163 The “lookthrough LRA” is the amount of income that would have been allocated to the converting corporation under section 704, including section 704(c),164 if the partnership had sold all of its LIFO inventory

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162 See supra note 15.
163 Reg. § 1.1363-2(b).
164 Neither the partnership nor any of its partners generally recognizes any gain or loss when property, including LIFO inventory, is contributed to the partnership in exchange for a partnership interest when the partnership is first formed or at any time thereafter. I.R.C. § 721(a). See also P.L.R. 2001-23-035 (Mar. 8, 2001). Any gain or loss built into the value of the contributed property at the time of the exchange is deferred by means of special rules that determine the contributing partner’s basis in the partnership interest received in the exchange and the partnership’s basis in the contributed property. I.R.C. §§ 722, 723.

To prevent the artificial shifting of precontribution built-in gains and losses among partners, section 704(c)(1)(A) requires that any gain or loss built into the value of property contributed by a partner to the partnership in exchange for a partnership interest under section 721(a) must be allocated back to the contributing partner upon the subsequent recognition of that gain or loss by the partnership. See also I.R.C. §§ 704(c)(1)(B), 737. See also infra note 184 (section 704(c) built-in gain of a transferor partner will sometimes carry over to a transferee of that partnership interest).
for the inventory’s FIFO value on the recapture date (or, under circumstances discussed below, on the first day of the partnership’s tax year that includes the recapture date).

The regulations permit and require a converting corporation to increase its outside basis in its “lookthrough partnership interest” by the amount of the lookthrough LRA that it recognizes as income under section 1363(d). Additionally, the partnership may elect to make a section 743(b)-type “special basis adjustment” for its LIFO inventory to reflect the amount of the lookthrough LRA recaptured by the converting corporation.

Example 1:

On January 1, 2002, X Corp and Y Corp, two calendar-year C corporations, formed calendar-year XY Partnership. On that date, X Corp contributed LIFO inventory (with an aggregate LIFO basis of $12M, a FIFO value of $18M, and a fair market value and “book value” of $20M) in exchange for a 50% partnership interest.165

Regulation section 1.1363-2(c)(3) defines a “lookthrough partnership interest” as an interest in a partnership that “owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method . . . .”

Reg. § 1.1363-2(e)(2)(i).

Reg. § 1.1363-2(e)(2)(ii). Where the LIFO inventory is held by a lower-tier partnership, an election is also available to the higher-tier partnership that will permit the higher-tier partnership to make a section 743(b)-type “special basis adjustment” with respect to the interest it owns in the lower-tier partnership. Reg. § 1.1363-2(e)(2)(ii). See infra Part VI.B. (“LIFO Inventory Held Indirectly Through a Partnership”).

Assume in this Example that the “book value” of the inventory, i.e., the amount that is used in determining the contributing partner's capital account under Regulation section 1.704-1(b)(2)(iv)(d), is the same value as its “fair market value” as that term is defined under Regulation section 1.704-1(b)(2)(iv)(d).
interest. Y Corp contributed $20M in cash for its 50% partnership interest. XY Partnership immediately elected the LIFO method by timely filing a Form 970.\textsuperscript{169}

Both the quantity of the partnership’s ending inventory and the replacement costs of the items in that inventory have risen steadily since the partnership’s formation.\textsuperscript{170} As of December 31, 2005, XY Partnership’s LIFO inventory had an aggregate LIFO basis of $15M, a FIFO value of $26M, and fair market value and book value of $29M. Consequently, of the total $14M of gain built into the value of the inventory on that date,\textsuperscript{171} $8M is pre-contribution built-in gain\textsuperscript{172} (which is ultimately allocable to X Corp under Section 704(c)), and $9M is post-contribution gain (which is ultimately allocable equally to X Corp and Y Corp). Of the $8M of X Corp’s

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\textsuperscript{169}There is no statutory mandate requiring (or permitting) the carry over of the transferor’s inventory accounting method to the partnership. Notwithstanding the transferor’s use of the LIFO method with respect to inventory it transfers to the transferee partnership, if the partnership wants to use LIFO with respect to that inventory it must generally make a timely election to do so. Textile Apron Co. Inc. v. Commissioner, 21 T.C. 147, 154 (1953), acq. 1954-1 C.B. 7. Even if it does make a timely LIFO election, the Service, in a closely analogous context, has ruled that in a nontaxable section 351 exchange in which LIFO inventory is transferred to a corporation in exchange for stock, only the transferor’s basis in the inventory, as a whole, carries over to a transferee corporation that does not already have a LIFO election in effect with respect to that type of inventory. The transferor’s base period and layers disappear, and the transferee treats the inventory as current-year purchases at the transferor's average costs. Rev. Rul. 70-564, 1970-2 C.B. 109.

But where the transferee is an existing partnership that is already using the LIFO method to account for the type of LIFO inventory that is contributed by the transferor partner, the transferor’s base year and layer structure carry over to the transferee. Commissioner v. Joseph E. Seagram & Sons, Inc., 394 F.2d 738, 743 (2d Cir. 1968), rev’g, 46 T.C. 698 (1966); Rev. Rul. 70-565, 1970-2 C.B. 110. See also, Reg. § 1.472-8(h) (accounting for dollar-value LIFO inventories received in a section 351(a) (or section 721(a)) transaction by a dollar-value LIFO-method corporation (or partnership)); Reg. § 1.704-3(e)(2)(iii) (election to aggregate certain inventory items for the purpose of making allocations under section 704(c)).

\textsuperscript{170}In other words, assume there has been no recognition of any of X Corp’s pre-contribution built-in gain.

\textsuperscript{171}$29M minus $15M = $14M total built-in gain.

\textsuperscript{172}$20M minus $12M = $8M pre-contribution built-in gain.
pre-contribution gain, $6M is pre-contribution LRA,\textsuperscript{173} and of the $6M of post-contribution built-in gain, $5M in post-contribution LRA.\textsuperscript{174}

If X Corp makes an S election effective as of January 1, 2006, its lookthrough LRA will be $8.5M: X Corp’s $6M pre-contribution built-in LRA plus its $2.5M share of the partnership’s post-contribution built-in LRA. Consequently, under the regulations, X Corp will be required to recognize gross income of $8.5M on its 2005 calendar-year C corporation income tax return under section 1363(d) and it will increase its basis in its XY Partnership interest by $8.5M.

The regulations also provide a special election under which XY Partnership may make a section 743(b)-type special basis adjustment of $8.5M (favoring X Corp) to its LIFO inventory.\textsuperscript{175}

The $2.5M balance of X Corp’s allocable built-in gain\textsuperscript{176} is not taxable under section 1363(d), but it may be subject to corporate-level taxes under section 1374 if and to the extent that the partnership, under the LIFO method,\textsuperscript{177} recognizes this gain on the disposition of the inventory within the ten-year recognition period.\textsuperscript{178}

If Y Corp makes an S election effective as of January 1, 2006, it will recognize a lookthrough recapture amount of only $2.5M on its final C corporation income tax return,\textsuperscript{179} and only $0.5M of

\textsuperscript{173}$18M minus $12M = $6M pre-contribution LRA.

\textsuperscript{174}26M minus $15M = $11M total LRA. $11M minus the $6M pre-contribution LRA = $5M post-contribution LRA.

\textsuperscript{175}Reg. § 1.1363-2(e)(2)(ii). This election is discussed and illustrated infra Part VI.B. (“LIFO Inventory Held Indirectly Through a Partnership”).

\textsuperscript{176}$8M total pre-contribution built-in gain minus $6M pre-contribution LRA recognized under section 1363(d) = $2M balance of pre-contribution built-in gain allocable to X Corp. $2M plus 50% of the $5M total post-contribution built-in gain minus $2M post-contribution LRA recognized under section 1363(d) = $2.5M.

\textsuperscript{177}Under Regulation section 1.1374-7(b), the inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the ten-year recognition period is inventory it held on the first day of that period. See infra, Part IV.E. (“Excess Built-in Gain May Be Subject to Section 1374”).

\textsuperscript{178}See also note 214 (limitation on amount of net unrealized gain built into the value of the partnership interest).

\textsuperscript{179}50% of the partnership’s $5M post-contribution LRA = $2.5M.
built-in gain will be potentially subject to section 1374.\textsuperscript{180}

1. The Lookthrough LRA

The proposed regulations stated that for the purpose of determining the lookthrough LRA, “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.”\textsuperscript{181} This definition lacked the specificity of the section 1363(d)(4)(C) definition, which requires that the FIFO value of the inventory be computed using the retail method (FIFO-Retail) or LCM (FIFO-LCM). This apparent oversight was corrected in final regulations, which provide that the FIFO value of the partnership’s LIFO inventory be “determined in accordance with section 1363(d)(4)(C).”

As a practical matter, the information required to determine the FIFO value of the partnership’s LIFO inventory under LCM may, in many instances, be unavailable. Under FIFO-LCM, the taxpayer must compare its cost of each item in its ending inventory to the replacement cost of that item as of the

\textsuperscript{180}50\% of the $6M total post-contribution built-in gain minus $2.5M post-contribution LRA recognized under section 1363(d) = $0.5M.

date the inventory is valued.\textsuperscript{182} If, as of the recapture date, the partnership holds LIFO inventory that had previously been contributed to it by the converting corporation in a nontaxable section 721(a) exchange, then, unless the converting corporation had otherwise been required to determine the FIFO-LCM value of that LIFO inventory as of the date of its contribution to the partnership,\textsuperscript{183} the detailed replacement cost information that would be required to retroactively determine the amount of the converting corporation’s section 704(c) LRA using FIFO-LCM may simply be unavailable in the subsequent recognition year.\textsuperscript{184}

Furthermore, the partnership may be unwilling to expend the time and effort required to gather the current replacement cost information or to make the frequently voluminous computations

\textsuperscript{182}See \emph{supra} note 130.

\textsuperscript{183}Taxpayers are not permitted to use LCM in accounting for their LIFO inventories. I.R.C. § 472(b)(2); Reg. § 1.472-2(b). However, a LIFO-method C corporation, in calculating its annual LRA adjustment to ACE (under section 56(g)) and to current E&P (under section 312(n)(4)), is generally required to determine the FIFO value of its LIFO inventories using the retail method or LCM. Where this was done, the converting corporation should be able to determine its section 704(c) LRA using FIFO-retail or FIFO-LCM, as the case may be. Reg. § 1.56(g)-1(f)(3)(iv). However, many C corporations are exempt from the AMT under the “small corporation exemption” of section 55(e). See \emph{supra}, note 136.

\textsuperscript{184}Note also that under Regulation 1.704-3(a)(7), any precontribution built-in gain that would have been allocated to a contributing partner under section 704(c) will be allocated to a transferee partner that either purchased that interest (assuming sections 754 and 743(b) were inapplicable at the time of the purchase) or acquired that interest in a nontaxable carryover-basis transaction (for example, in an exchange qualifying under section 351 or section 354). Since LIFO method taxpayers other than C corporations seldom, if ever, need to determine the FIFO value of their LIFO inventories, then, where the converting corporation’s lookthrough partnership interest was so acquired from a non-C corporation transferor, the information required to determine the transferor’s section 704(c) LRA using FIFO-LCM will most likely be unavailable.
required to determine the contribution-date or recapture-date FIFO value under LCM, especially where the converting corporation holds a minority partnership interest and the partnership is not otherwise required to determine the inventory’s FIFO value.\footnote{A C corporation that holds an interest in a LIFO-method partnership must compute its annual “change-in-LRA” adjustment to ACE on a “lookthrough” basis. \textit{Preamble}, T.D. 8454, 1993-1 C.B. 5 (“Similarly, a corporate partner takes into account its proportionate share of the partnership’s LIFO inventory assets for the partnership taxable year that ends within or with the corporation’s taxable year.”). A lookthrough approach would also seem to be required for the purpose of computing the C corporation’s LRA adjustment to its current E&P. \textit{See Rev. Rul. 79-20}, 1979-1 C.B. 137 (which requires each C-corporation partner to adjust its distributive share of partnership earnings for the difference between the amount of depreciation claimed by the partnership in deriving those earnings and the amount of depreciation permitted under section 312(k)).}

The use of FIFO-LCM will invariably produce an LRA that is less than, or at least not greater than, it would have been using FIFO-cost. If the converting corporation or the partnership does not have the information, or the motivation, required to calculate either the pre-contribution LRA, or the recapture-date LRA, or both, using FIFO-LCM, the use of the FIFO-cost method should, by default, suffice.

2. \textit{Recapture Date for Determining the Lookthrough LRA}

Under the general rule, the amount of the lookthrough LRA is determined on the recapture date.\footnote{Reg. \S 1.1363-2(c)(4)(ii). As in the case of LIFO inventory held directly by the converting corporation, the LRA is determined at the close of}
recapture date may be difficult or impracticable where the recapture date occurs at a time other than on the last day of the partnership’s tax year, particularly where the converting corporation holds a minority interest in the partnership. The regulations allow for this possibility and ameliorate the general rule by permitting the converting corporation to use the LRA built into the partnership’s opening inventory for the partnership’s taxable year that includes the recapture date if the partnership is not otherwise required to determine the inventory’s LIFO value on the recapture date itself. Where the opening inventory values are used to calculate the LRA, this tentative amount will be adjusted by including any LIFO inventory subsequently contributed by a partner to the partnership on or before the recapture date (taking into account section 704(c)), and by excluding any inventory subsequently distributed by the partnership under section 731 to a partner on or before that date.\textsuperscript{187}

The proposed regulations failed to consider the possibility that the partnership may have been required to adjust its basis in its LIFO inventory as a result of certain transactions that occurred subsequent to the start of the partnership’s tax year

\textsuperscript{187} The recapture date where section 1363(d) is triggered by the converting corporation’s S election, and as of the moment before the transfer occurs where it is triggered by the transfer of a C corporation’s assets to an S corporation in a nontaxable carryover-basis transaction.
and on or prior to the recapture date. These adjustments include:

1. Any adjustments to the partnership’s LIFO inventory basis required under section 751(b) where a distributee partner receives a distribution that includes less than the distributee partner’s proportionate share of the partnership’s unrealized receivables and inventory;

2. Any adjustments to the partnership’s LIFO inventory basis required under section 734(b) as a result of a liquidating or nonliquidating distribution of cash or other property to one or more of the partners;

3. Any adjustments to the partnership’s LIFO inventory basis required under section 737(c) as a result of a noncash distribution to the converting corporation that triggers the recognition of part or all of the pre-contribution gain built into the value of LIFO inventory that the converting corporation had previously contributed to the partnership under section 721; and

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187 Reg. § 1.1363-2(c)(4)(iii).
188 There is no statutory, administrative, or judicial guidance as to how the interim LIFO value of a partnership’s inventory is to be determined for any of the purposes listed in the following text. But see Reg. § 1.1502-13(e)(1)(iii)-(v), Ex. (1), (3) (simplifying rules that apply to interim sales of dollar-value LIFO inventory between members of a consolidated group).
189 I.R.C. § 751(c).
190 I.R.C. § 751(d). The partnership receives a cost basis in a portion of its undistributed unrealized receivables and inventory automatically, without regard to whether a section 754 election is in effect. See Reg. § 1.751-1(g), Ex. (2)(e)(1), (3)(e)(1), (4)(e)(1), (5)(e)(1).
191 Section 734(b) applies only where the partnership has a section 754 election in effect. The adjustment required under section 734(b) is allocated between and among the partnership’s retained assets in accordance with the rules set forth in section 755 and Regulation section 1.755-1.
192 Under section 737(a), if a partner receives a distribution of non-cash property having a fair market value in excess of that partner’s basis in its partnership interest (after reduction for any money distributed in the same distribution), then the distributee partner must recognize gain on the distribution in an amount equal to the lesser of that excess or the distributee’s “net precontribution gain.” I.R.C. § 737(a). Section 737(b) defines the “net precontribution gain” as the “net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if all property [including LIFO inventory] which (1) had been contributed to the partnership by the distributee partner within 7 years of the distribution,
4. Any “special basis adjustments” made with respect to the partnership’s LIFO inventory that were required under section 743(b) where the converting corporation acquired an interest in the partnership in a sale or exchange in which the seller recognized gain or loss in whole or in part.¹⁹³

The final regulations correct this oversight.¹⁹⁴ Where the partnership is not otherwise required to determine its inventory’s LIFO value on the recapture date itself, it must

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¹⁹³Section 743(b) applies only where the partnership has a section 754 election in effect. The adjustment required under section 743(b) is allocated between and among the partnership’s assets in accordance with the rules set forth in section 755 and Regulation section 1.755-1. See infra Part VI.B. (“LIFO Inventory Held Indirectly Through a Partnership”). (discussion of section 743(b)).

¹⁹⁴Regulation section 1.1363-2(c)(4)(iii) reads as follows:

Alternative rule. 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. A partnership that applies the alternative method of this paragraph (c)(4)(iii) to calculate the lookthrough LIFO recapture amount must take into account any adjustments to the partnership’s basis in its LIFO inventory that result from transactions occurring after the start of the partnership's taxable year and before the end of the recapture date. For example, the lookthrough LIFO recapture amount must be adjusted to take into account any adjustments to the basis of LIFO inventory during that period under sections 734(b), 737(c), or 751(b).
instead use the LRA built into its inventory as of the later of (1) the first day of the partnership's taxable year that includes the recapture date, or (2) the most recent prior date on which the partnership was required to determine its LIFO inventory value for any purpose under Subchapter K.195

3. Reverse Section 704(c) Allocations

Neither the proposed nor the final regulations under section 1363(d) anticipate a scenario wherein a portion of a partnership’s LRA might escape section 1363(d) through the threshold admission of a new partner (or an increase in another partner’s interest in the partnership). Upon the admission of a new partner (or an increase in another partner’s interest in the partnership), Regulation section 1.704-1(b)(2)(iv)(f) permits, but does not generally require, the partnership to revalue its assets and to make corresponding adjustments to the partners' capital accounts on the partnership’s books.196 These adjustments

195 Where either of these inventory values are used, the tentative LRA so derived must be further adjusted by including the LRA of any inventory subsequently contributed to the partnership by the converting corporation on or before the recapture date, and by excluding any inventory subsequently distributed by the partnership under section 731 to any partner, including the converting corporation (to prevent double-counting), on or before that date.

196 Reg. § 1.704-1(b)(2)(iv)(f). The regulations permit the partners' capital accounts to be increased or decreased to reflect the revaluation of partnership property on the partnership's books if the adjustments are made principally for a substantial nontax business purpose and the adjustments are made either (1) in connection with a contribution or distribution of money or
are generally referred to as “reverse section 704(c) allocations.” If the partnership does not elect to make these allocations, a portion of the inside gain or loss built into each of the partnership’s assets might be allocated away from the existing partners and to the incoming partner.\textsuperscript{197}

Example 2:

On January 1, 1990, X Corp and Y Corp, two calendar-year C corporations, formed calendar-year XY Partnership. Each contributed cash for a 50\% partnership interest. All of the stock of X Corp is owned by Individual X and all of the stock of Y Corp is owned by Individual Y. On its tax return for its 1990 calendar year, the partnership adopted the LIFO method to account for its inventory.

Sometime prior to December 31, 2005, Individuals X and Y each contributed a personal note to XY Partnership in exchange for a 25\% interest therein. At

\textsuperscript{197}But see Reg. § 1.704-1(b)(1)(iii):

The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. . . . [A]n allocation that is respected under section 704(b) . . . nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), . . . .
the time of these exchanges and at December 31, 2005, the partnership’s inventory had a LIFO basis of $10M, a FIFO value of $18M, and a fair market value and book value of $20M. X Corp and Y Corp each makes an S election that will become effective as of January 1, 2006.

If the partnership agreement provides for the revaluation of the partnership’s assets upon the admission of a new partner, then the entire unrealized gain (including the LRA) built into the value of the partnership’s LIFO inventory as of the date of the admission of Individuals X and Y will be allocable to X Corp and Y Corp when that gain is subsequently recognized. Consequently, X Corp and Y Corp will each recognize gross income of $4M, their respective shares of the partnership’s $8M LRA, on December 31, 2005 under Regulation section 1.1363-2(b)(1).

However, if the partnership does not revalue its assets upon the admission of Individuals X and Y, then, but for the assertion and successful prosecution of an anti-avoidance rule (for example, section 482, the assignment of income doctrine, etc.) by the Service, each of these corporations would recognize a LRA of only $2M, and the $4M balance, now allocable to the two new individual partners, would permanently escape corporate-level taxation.

To prevent this type of avoidance, the author suggested that the proposed regulations be revised to include an objective rule that would require the retroactive revaluation of LIFO inventories under Regulation section 1.704-1(b)(2)(iv)(f) when a non-C corporation partner has been admitted to a partnership (or has increased his, her, or its relative interest in the partnership) within a period of two, or perhaps seven, years.

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198 See supra note 197.

199 Similar anti-avoidance two-year look-back rules can be found in section 269(b)(1)(C) (acquisitions made to avoid or evade income tax), section 5881(b)(1) (definition of “greenmail”), section 1059(a) (basis
ending on the date when a C corporation partner in the same partnership makes an S election (or transfers its partnership interest to an S corporation in a nontaxable carryover-basis transaction).\textsuperscript{201} This recommendation was determined to be beyond the scope of these regulations and was not included in the final regulations.\textsuperscript{202}

D. Entire LRA Must Be Recaptured

1. Pre-Effective-Date Accruals of the LRA

\textsuperscript{200}See, for example, the seven-year period specified in section 704(c)(1)(B) (and by cross-reference, section 737).


The author also suggested that this period might be extended indefinitely where the non-C corporation partner is related to the converting corporation, at least where that partner’s admission or increase in partnership interest was motivated by a principal purpose of minimizing the imposition of taxes upon the subsequent conversion of the related C corporation partner to S status (or upon the subsequent disposition of its lookthrough partnership interest to an S corporation in a nontaxable carryover-basis transaction).

Section 1363(d) requires the recognition of the entire LRA built into the converting corporation’s LIFO inventories as of the recapture date. Consequently, although section 1363(d) generally applies only to S elections that take effect after December 17, 1987, to nontaxable C corporation-into-S corporation asset transfers taking place after August 18, 1993, and to LIFO inventories held indirectly by a C corporation through a partnership with respect to S elections and transfers made on or after August 13, 2004, if the LIFO method for the inventory in question had been adopted prior to the relevant effective date, then section 1363(d) and the regulations thereunder will have retroactive effect. Neither the statute nor the regulations provide an exemption for any LRA built into the inventory as of the applicable effective date.

203Reg. § 1.1363-2(g)(1). But see supra note 7.
204Reg. § 1.1363-2(g)(2).
205Reg. § 1.1363-2(g)(3).
206For example, if the LRA of a C corporation as of December 17, 1987 had been $5 million and had grown to $12 million as of the effective date of its S election in 2006, the entire $12 million, not just to $7 million post-effective-date increase, would be subject to section 1363(d).

Nor do section 1374 or any of the other provisions implementing the repeal of General Utility exempt gains built into the value of a C corporation’s assets as of their effective date.

By contrast, the adjustments mandated in 1984 under section 312(n)(4)(A) (E&P) and in 1989 under section 56(g)(4)(D)(iii) (ACE) apply only to net increases in the LRA occurring after the effective dates of these provisions (tax years beginning after September 30, 1984 and December 31, 1989, respectively). The cumulative balance of the LRAs that existed as of the beginning of the first tax year for which these provisions became effective are generally not reflected in the corporation’s E&P or in its ACE unless and until these amounts are recognized for regular income tax purposes. But see infra notes 273 and 320 (cumulative net negative
2. Pre-immersion Accruals of the LRA

...adjustments to ACE, but not to E&P, can fall below the positive LRA balance that existed as of the effective date of section 56(g)(4)(D)(iii).
Nor do the statute or regulations anywhere provide an exemption for the LRA that was built into the value of the LIFO inventory of a non-C corporation as of the date that the inventory was transferred to a C corporation in a nontaxable carryover basis transaction. Thus, for example, where a converting corporation previously acquired its LIFO inventory from an individual, a partnership owned by noncorporate partners, or an S corporation in a nontaxable carryover basis transaction to which section 362(a) or section 362(b) applied, the recapture rules make no distinction between the portion of the converting corporation’s LRA that had accrued as of the date of the acquisition and the portion that accrued while that inventory was held in C corporation solution.207 Similarly, no

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207 The lack of symmetry between the anti-avoidance rules that are so consistently applied to “outbound” built-in gains, and the conspicuous absence of any rules that would otherwise prevent the imposition of corporate-level taxes on “inbound” built-in gains, is pervasive throughout the tax law. “Outbound” built-in gains, as that term is used here, are gains that would have been subject to corporate-level taxation had they been recognized in the year of their economic accrual. The Code invariably taxes these built-in gains whenever the assets into which they are built are removed from C corporation solution. E.g., I.R.C. §§ 1363(d), 1373(b), 1374 (but generally only if and to the extent the built-in gain is recognized within the ten-year recognition period), 336, 311(b), and 361(c)(2). By contrast, outbound built-in losses are, with limited exceptions, permanently disallowed. E.g., I.R.C. §§ 311(a) and 301(d), 336(d) and 334(a), and 361(c)(1) and 358(a)(2).

“Inbound” built-in gains are gains built into the value of:

1. assets held directly, or, in the case of a partnership, indirectly, by a non C-corporation taxpayer as of the date those assets are transferred to a C corporation in a nontaxable section 351 exchange,

2. assets held by an S corporation as of the date those assets are transferred to a C corporation in a nontaxable carryover-basis transaction (under section 351 or section 368), or
such distinction is made where the LIFO inventory was held by
the converting corporation prior to the termination or
revocation of a previous S election,\textsuperscript{208} or where the converting

(3) assets held by an S corporation at the time that its S election
is revoked or terminated.

Although there is nothing in the Code, regulations, administrative
rulings, or case law that would exempt inbound built-in gains from corporate-
level taxation when those gains are subsequently recognized by a C
corporation, some commentators have speculated that, at least under some
circumstances, pre-immersion LRA might not (or at least should not) be
subject to section 1363(d). See American Bar Association, ABA Members Object
to Scope of LIFO Recapture Regs, 61 Tax Notes (TA) 544 (Nov. 1, 1993):

The Regulation should also address the situation where a sole
proprietorship incorporates under Section 351 but does not
immediately make an S election. It is unclear whether the LIFO
recapture amount would be the LIFO layers of inventory
acquired while a C corporation or would also include those
layers acquired as a sole proprietorship. The holding of
[P.L.R.] 9039005 might suggest the former but the statutory
language would appear to suggest the latter.

See also Ronald S. Ross and John L. Kramer, LIFO Recapture Tax Issues
Remain Despite New Regulations and a Revenue Procedure. 82 J. Tax’n 92, 97
(1995):

What about a sole proprietorship using the LIFO method that
incorporates under Section 351, but does not immediately make
an S election? The Regulations do not discuss this situation
either. Presumably the LIFO recapture tax applies because the
entity exists for a period as a C corporation. [footnote
omitted] It is not clear, however, whether the LIFO inventory
layers for Section 1363(d) tax purposes are those layers
acquired while a sole proprietorship and a C corporation, or
just those layers acquired while a C corporation. Logically,
only those layers acquired while a C corporation should be
tainted and subject to the recapture tax.

\textsuperscript{208}The Service has held that an election to treat a subsidiary as a QSub
terminates if the S corporation transfers 100\% of the QSub’s stock (whether
by sale or reorganization under sections 368(a)(1)(A), (C), or (D)), to
another S corporation in a transaction that does not qualify as a
reorganization under section 368(a)(1)(F). The transferor S corporation’s
QSub election for its QSubs does not carry over to the acquiring S
corporation. Instead, this election terminates as of the close of the
acquisition date, unless the acquiring S corporation makes a QSub election
for these subsidiaries effective immediately following the termination. Reg.

If no such election is made, any LRA built into a former QSub’s LIFO
inventory as of the date of the acquisition will be immersed in C corporation
solution and any income resulting from the subsequent recognition of that
amount (including recognition under section 1363(d) if and when a subsequent
corporation purchased an interest in a LIFO-method partnership from a non-C corporation partner prior to its conversion to S status. 209

Example 3:

In 2002, Individual T transferred all of the assets of her sole proprietorship to a new corporation in exchange for its stock. The exchange qualified under section 351 and T’s basis in the transferred assets carried over to the corporation under section 362(a). Among the assets transferred was LIFO inventory that had an LRA of $1M. The new corporation made an S election that was effective from the date of its formation.

In 2005, at a time when the LRA built into the value of the LIFO inventory had steadily increased to $2M, the assets of the S corporation were acquired by a C corporation in a nontaxable Type A reorganization under section 368(a)(1)(A). The C corporation subsequently made an S election effective as of January 1, 2007. The LRA built into the value of the LIFO inventory as of that date had increased to $3M.

The corporation’s conversion to S status will trigger the recognition of the entire $3M LRA notwithstanding the fact that $2M of that amount had accrued outside of C corporation solution, (i.e., at a time when its recognition would not have been subject to corporate-level income taxes).

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209 Note, however, that under section 743(b), the pre-immersion gain built into the value of the purchasing C corporation’s share of the partnership’s LIFO inventory as of the date of its acquisition of the partnership interest disappears if the partnership had a section 754 election in effect on the date of the purchase. See infra notes 219 and 220 and accompanying text.
3. *Recapture Not Limited to Net Unrealized Built-in Gain*

The upper limit on the amount of recognized built-in gain that can ultimately be subject to corporate-level taxes under section 1374 is the converting corporation’s net unrealized built-in gain.\textsuperscript{210} Section 1363(d), however, does not similarly restrict the amount of LRA that must be recognized as gross income by the converting corporation. For example, a converting corporation with a LRA of $1 million and a net unrealized built-in ordinary loss of $3 million as of the date of its conversion to S status will be required to recognize the entire $1 million LRA as income under section 1363(d), notwithstanding the fact that it has a net unrealized built-in loss of $2 million. Furthermore, since net operating losses arising in S years cannot be carried over to C years,\textsuperscript{211} even if the converted corporation\textsuperscript{212} were to recognize some or all of its built-in losses within the first two years of its S election, it would be

\begin{footnotesize}
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\item[210] I.R.C. § 1374(c)(2), (d)(1). See supra note 15 ("net unrealized built-in gain" defined). Note, however, that section 1374 does not bifurcate the net unrealized built-in gain into its net ordinary income and net capital gain components in determining the limit on the amount of net recognized built-in gain or income that will be subject to the corporate-level tax. I.R.C. § 1374(d)(1); Reg. § 1.1374-3.

\item[211] I.R.C. § 1371(b)(2).

\item[212] I.e., the converting corporation itself following its S election, or, following a nontaxable carryover-basis transaction, the transferee S corporation.
\end{footnotes}
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not be permitted to carry these losses back to reduce the income previously recognized under section 1363(d).\textsuperscript{213}

The regulations governing the respective application of section 1374 and section 1363(d) to a converting corporation that owns an interest in a partnership are likewise incongruent. Generally speaking, the regulations under section 1374 limit the total amount of recognized built-in gain that a converting corporation must recognize on account of its ownership of an interest in a partnership to the unrealized gain, if any, built into the value of the partnership interest as of the date of conversion.\textsuperscript{214} By contrast, the regulations under section 1363(d)

\textsuperscript{213}\textit{See also I.R.C. § 381(b)(3) (which prevents a transferee corporation from carrying any post-acquisition losses back to offset the pre-acquisition taxable income of the transferor corporation, even where such losses were built into the value of the transferor's assets as of the date of its nontaxable acquisition in a Type A, Type C, nondivisive Type D, or nondivisive Type G reorganization); see generally David. W. LaRue, A Case for Neutrality in the Design and Implementation of the Merger and Acquisition Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations, 43 Tax L. Rev. 85, 28-240 (1987).}

\textsuperscript{214}Reg. § 1.1374-4(i)(4). If an S corporation held an interest in a partnership as of the date of its conversion to S status, these regulations adopt a look-through rule. Under this rule, the corporation must generally treat its distributive share of any gain or loss built into the partnership's assets as of the date of the corporation's conversion and recognized by the partnership in the current year as a recognized built-in gain or loss. However, subject to several refinements for post-conversion contributions, distributions, etc. and to a special anti-avoidance rule, the maximum amount of recognized built-in gains or losses that the S corporation partner can recognize under section 1374 during the ten-year recognition period is limited to the net amount of gain or loss built into the value of its partnership interest as of the date of conversion.

Regulation section 1.1374-4(i)(5) provides a de minimis exception from this burdensome rule. The lookthrough approach does not apply in recognition years where the S corporation's interest in partnership capital and profits is less than ten percent and is worth less than $100,000 at all times during that year. This exception does not apply in any subsequent year where the value of the partnership interest exceeds $100,000. Under Regulation section
do not limit the amount of lookthrough LRA that a converting corporation must recognize as income to the amount of net unrealized gain (or even the net unrealized ordinary income) built into the value of its lookthrough partnership interest. The problem can be particularly acute where, prior to its conversion to S status, the converting corporation had purchased an interest in a LIFO-method partnership for which a section 754 election was not in effect (or made retroactively to the beginning of the year of purchase).215

Given the shared purpose that prompted the enactment of section 1374 and section 1363(d),216 the failure of the latter to limit its application to the amount of the converting corporation’s net unrealized built-in gain (or at least its net unrealized built-in ordinary income), if any, as of the date of its conversion is a failure in policy that, in the author’s opinion should be remedied by statute.217

1.1374-4(i)(5)(iii), this exception will not apply to any partnership that was used to avoid the built-in gains tax (for example, where an S corporation stuffs appreciated assets in multiple partnerships that would otherwise qualify for the exception).


216Both of these provisions serve the same general purpose of preventing income and gain that is economically attributable to a C-year from escaping corporate-level taxes through the conversion of a C corporation to an S corporation. See supra Part I.A. (“Historical Context”).

217This problem could be corrected by amending section 1363(d) to so limit its application, or, alternatively, by repealing section 1363(d) and instead taxing the post-conversion liquidations of a converting corporation’s
Finally, where an S corporation makes a QSub election with respect to a wholly-owned LIFO-method C corporation subsidiary, the amount of the LRA that must be recognized under section 1363(d) is not limited to the amount of gain, if any, built into the value of the subsidiary’s stock as of the date of the deemed liquidation. This is true regardless of whether it is the parent or the subsidiary itself that is required to recognize the LRA on its final C corporation return.\footnote{As previously observed, where the parent corporation makes an S election and simultaneously makes a QSub election for one or more of its wholly-owned subsidiaries, the subsidiary is deemed to liquidate into the parent under sections 332 and 337 immediately before the parent’s S election takes effect. See supra note 63 and accompanying text. As a result, the parent’s basis in the stock of the subsidiary disappears and its basis in the LIFO inventory it is deemed to have received in the deemed liquidation is a carryover-basis under section 334(b). The entire amount of the subsidiary’s LRA is reported as income on the parent’s final C corporation return.}

4. Purchase of an Interest in an Existing LIFO-Method Partnership

Where a C corporation purchases an interest in a partnership that holds LIFO inventory, the selling partner will be required to recognize its distributive share of the LRA built into the partnership’s LIFO inventory at the time of the sale as ordinary income under section 751(a). If the partnership has a pre-conversion LIFO reserves under section 1374, as recommended by the author. See infra Part VIII (“CONCLUSION”).

\footnote{As previously observed, where the parent corporation makes an S election and simultaneously makes a QSub election for one or more of its wholly-owned subsidiaries, the subsidiary is deemed to liquidate into the parent under sections 332 and 337 immediately before the parent’s S election takes effect. See supra note 63 and accompanying text. As a result, the parent’s basis in the stock of the subsidiary disappears and its basis in the LIFO inventory it is deemed to have received in the deemed liquidation is a carryover-basis under section 334(b). The entire amount of the subsidiary’s LRA is reported as income on the parent’s final C corporation return. Where the QSub election is made at a time when the parent already has an S election in effect, the deemed liquidation will trigger the recognition of its LRA into income that the subsidiary will report on its final C corporation return.}
section 754 election in effect, the adjustments required under section 743(b) will prevent the incoming C corporation’s share of the LRA built into the partnership’s LIFO inventory at the time of the purchase from being taxed to it under Regulation section 1.1363-2(b) if and when that corporation subsequently makes an S election (or subsequently transfers its partnership interest to an S corporation in a nontaxable carryover-basis transaction).

However, if a section 754 election was not in effect, these events will trigger the converting corporation’s taxable recognition of “phantom” LRA—i.e., “income” that does not comport with the economic realities of the converting corporation’s investment in the partnership, income that has already been fully taxed, as ordinary income, to the seller at the time that the converting corporation purchased its interest in the partnership.220

219A section 754 election is made by the partnership by filing a statement with its return for its taxable year for which the election first applies. Reg. § 1.754-1(b). Consequently, the election can be made retroactively to cover the preceding tax year if made on or before the extended due date for the partnership return. (Under Regulation section 301.9100-2, an automatic 12-month extension from the due date for making a section 754 election is available provided the taxpayer takes “corrective action,” but regardless of whether the partnership filed a timely return for the year the election should have been made.)

An election, once made, remains in effect until revoked. Revocation requires the consent of the District Director. Reg. § 1.754-1(c).

220Under the general rule of section 743(a), the sale or exchange of a partnership interest does not trigger an adjustment by the partnership to its basis in its assets. But see infra note 225(exception in the case of certain partnerships with substantial net unrealized built in losses).
Example 4:

On January 1, 1990, X Corp and Y Corp, two calendar-year C corporations, formed calendar-year XY Partnership. Each contributed cash for a 50% partnership interest. On its tax return for its 1990

This is true even where the purchase of the partnership interest results in a termination of the partnership under section 708(b)(1)(B). Prior to May 9, 1997 (or, in some cases, May 9, 1996), Regulation section 1.708-1(b)(1)(iv) treated the termination as if (1) the partnership had distributed its properties to the purchasing partner and the continuing partners in proportion to their respective interests in the partnership properties, and, immediately thereafter, (2) the purchasing partner and the continuing partners contributed the properties to a new partnership in exchange for an interest in that partnership. Generally, no gain or loss was recognized by the terminating partnership, the purchasing partner, or the continuing partners as a result of the deemed liquidation or the deemed contribution. I.R.C. §§ 731(a), (b), 721(a).

The current regulations under Regulation section 1.708-1(b)(4), which are applicable to partnership terminations occurring on or after May 9, 1997 (or, at the election of the partnership, on or after May 9, 1996), reverse the previous fictional order of events. These regulations treat the termination as if the partnership contributed all of its assets and liabilities to a new partnership in exchange for an interest in that partnership, and then made a liquidating distribution of its interest in the new partnership to the purchasing partner and continuing partners in proportion to their respective interests in the terminated partnership. As under the previous regulations, no gain or loss is generally recognized by the terminating partnership, the purchasing partner, or the continuing partners as a result of the deemed contribution or the deemed liquidation. I.R.C. §§ 721(a), 731(a), (b).

Under both the old and the new regulations, the new partnership’s initial basis (and LRA) in the terminated partnership’s LIFO inventory will initially be the same as the terminated partnership’s basis (and LRA) in that inventory. I.R.C. §§ 732(c)(1)(A), 723 (under the old section 708 regulations); I.R.C. § 723 (under the new section 708 regulations). See supra note 169(discussion of the new partnership’s adoption of the LIFO method and the effect that the deemed contribution may have on the inventory’s LIFO layers).

If a timely section 754 election is made by the terminated partnership (or if the terminated partnership already had a section 754 election in effect), the election will apply to the incoming partner whose purchase triggered the termination. If a section 754 election is in effect, the terminating partnership’s adjusted basis in its assets is adjusted (under sections 743(b) and 755) prior to the deemed contribution of these assets to the new partnership. Reg. § 1.708-1(b)(5). Any section 743(b) basis adjustments that either the purchasing partner or a continuing partner had with respect to the terminating partnership’s property will continue with respect to that property in the hands of the new partnership after the termination, regardless of whether the new partnership makes a section 754 election. Reg. § 1.743-1(h)(1).
calendar year, the partnership adopted the LIFO method to account for its inventory.

For the sake of simplicity, assume that as of December 31, 2002, the partnership had no liabilities and its only asset was inventory which, on that date, had a LIFO basis of $10M, a FIFO value of $18M, and a fair market value of $20M. Assume further that X Corp’s basis in its partnership interest was $5M and that on December 31, 2002, Z Corp purchased X Corp’s interest in XY Partnership for $10M in cash. The partnership did not have and did not make a section 754 election.

Z Corp subsequently makes an S election that will be effective on January 1, 2006. As of December 31, 2005, the partnership’s only asset was its inventory, which still had a LIFO basis of $10M, a FIFO value of $18M, and a fair market value of $20M.

In 2002, X Corp will recognize all of its share of the gain built into the value of the inventory, including the component of that value represented by the LIFO reserve, as ordinary income under section 751(a), and Z Corp will take a basis in the partnership interest of $10M.

However, notwithstanding the fact that Z Corp, in essence, paid full value for its interest in the LIFO inventory, section 743(a) would not have permitted the partnership to make a “special basis adjustment” that would have otherwise stepped-up Z Corp’s basis in the inventory and prevented it from subsequently recognizing income that it never really had. Consequently, when Z Corp makes an S election effective as of January 1, 2006, it will be required to recognize its $4M share of the partnership’s December 31, 2005 LRA as ordinary gross income on its 2005 calendar-year tax return.\(^\text{221}\)

\(^{221}\)Of course, the recognition of this income would have the collateral effect of increasing Z Corp’s basis in its partnership interest under Regulation section 1.1363-2(e)(2)(i) to $14M (the value of the interest is still only $10M), thereby creating a $4M built-in capital loss that Z Corp would eventually recognize upon a subsequent sale or exchange of its partnership interest (or at or subsequent to the time that it completely liquidates its interest in the partnership or the partnership itself liquidates). I.R.C. §§ 741, 731(a), 732.

Given the fact that any future recognition of this loss is generally unlikely to produce corporate-level tax savings (unless such losses can be
In the author’s opinion, the proposed regulations should have been, but were not, modified to prevent this result. Where a C corporation acquires a lookthrough partnership interest in a purchase (or in an exchange that is fully taxable to the selling partner) and the partnership has no section 754 election in effect at the time of the acquisition, the purchasing C corporation should be permitted to make a contemporaneous protective section 743(b)-type adjustment to the partnership’s LIFO inventories. Furthermore, where, as a result of indifference, inadvertence, or lack of foresight, the converting corporation failed to make a protective section 743(b)-type adjustment at the time of its acquisition of the lookthrough partnership interest, then, if the partnership’s books and records relating to its LIFO inventory are sufficient to make an accurate determination of the amount of the

\[\text{used to offset capital gains recognized under section 1374 within the ten-year recognition period}, \text{ given the limitations imposed on the utilization of capital losses, and given the diminution of the present value of whatever tax savings might eventually result where the event that ultimately triggers the recognition of this built-in loss occurs at some distant point in the future, the net effect to Z Corp is a burdensome net tax on income that it never really had.}\]

\[\text{\textsuperscript{222}See supra note 201. This recommendation was determined to be beyond the scope of the section 1363(d) regulations. Preamble, T.D. 9210, 2005-33 I.R.B. 290.}\]
adjustment, the converting corporation should be permitted to make this adjustment retroactively. Either way, this adjustment would be taken into account only if and when the corporation subsequently converts to S status (or transfers its lookthrough partnership interest to an S corporation in a nontaxable carryover-basis transaction), and it would apply only for the purpose of limiting the amount of LRA that must be recognized under section 1363(d).

This special treatment is, in the author’s opinion, warranted for several reasons. First, and foremost, it would prevent a converting corporation from being taxed under section 1363(d) on phantom income, that is, income that results from anomalies in the technical application of Subchapter K, rather than from the economic realities of the converting corporation’s investment in the partnership; income that has, in fact, already been fully taxed (to the seller). Rules designed to prevent the

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223 LIFO-method taxpayers are required, as a condition of adopting and using the LIFO method, to keep fairly detailed records going back all the way to the year the LIFO method was adopted. Reg. § 1.472-2(h). The Service takes the position that failure to maintain adequate books and records can be grounds for termination of the LIFO election. Rev. Proc. 79-23, § 3.01(d), 1979-1 C.B. 564. See Stephen F. Gertzman, Federal Tax Accounting 7-28, 7-29 (2d ed., Warren Gorham Lamont, Boston, 1993):

The LIFO method is based on the concept that the last goods acquired are the first goods sold. Accordingly, the earliest goods acquired are treated as the goods remaining in inventory. As a consequence, LIFO computations are often based on data accumulated at the beginning of the year of the adoption of LIFO. It is essential that the taxpayer retain all books, records, worksheets and other material supporting its LIFO computations throughout the period of its adoption and use of LIFO.
taxation of phantom income or the multiple taxation of the same income are laudable wherever they exist, but, given the draconian nature of section 1363(d), they would be especially welcome in this context.

Second, although a timely election under section 754 would solve this problem, this election would have to have been effective for the date that the C corporation acquired its partnership interest. The directors and shareholders of a C corporation often lack the clairvoyance required to anticipate the subsequent conversion of their corporation to S status, or the subsequent disposition of its assets to an S corporation in a nontaxable carryover-basis transaction. Furthermore, even where the possibility of a subsequent conversion event is anticipated, a C corporation that acquires a minority interest in the lookthrough partnership may not be able to compel the partnership to make a section 754 election. And although the

224 See infra Part VIII ("CONCLUSION").

225 Prior to October 10, 2004, one deterrent to making a section 754 election was the fact that, since the operational provisions that this election animates (sections 734(b), 743(b), and 755) were more or less symmetrical in their application to built-in gains and to built-in losses, the election frequently resulted in unfavorable negative adjustments to the partnership’s asset bases. This deterrent was, for the most part, eliminated by the amendments made to sections 734 and 743 by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. To prevent partnership losses from shifting to new or existing partners, sections 734 and 743 now, with limited exceptions, require partnerships that do not have a section 754 election in effect to make these downward basis adjustments where the partnership has a net unrealized built-in loss of $250,000 or more. Since basis step-downs are now mandatory, partnerships that previously failed to make a section 754 election in order to avoid them may now wish to consider a section 754 election to obtain the benefit of basis step-ups.
complex calculations and recordkeeping burden required to implement a full-blown section 754 election can be extremely cumbersome, restricting section 743(b)-type adjustments to the lookthrough LRA of an incoming C corporation partner, and only for the purpose of applying section 1363(d) upon that partner’s subsequent conversion to S status, would be relatively simple and straightforward.

E. Excess Built-in Gain May Be Subject to Section 1374

Recognition of the LRA under section 1363(d) does not necessarily eliminate all of the gain built into the converting corporation’s LIFO inventory. Even when inventory is accounted for under the FIFO method, its fair market value can exceed its tax basis. This is particularly true with respect to inventory that is manufactured by the converting corporation. Only the corporation’s LRA is taxable under section 1363(d). The excess of the inventory’s fair market value over its FIFO value is not subject to section 1363(d), but may ultimately be taxed as built-in gain under section 1374 if, under the LIFO cost-flow
assumption,\textsuperscript{226} that inventory is disposed of within the ten-year recognition period.\textsuperscript{227}

Example 5:

Z Corp’s ending inventory at the time of its conversion to S status has a LIFO basis of $100,000. Under FIFO, its basis would have been $135,000. The “fair market value” of the inventory (discussed below) is determined to be $150,000.

Although there is a total of $50,000 of gain built into the value of the inventory, only $35,000 will be subject to section 1363(d). Z Corp’s basis in the inventory will be stepped up to $135,000 to reflect the recognition of this gain.\textsuperscript{228} The $15,000 balance of the gain built into the value of the inventory is potentially subject to section 1374 if and to the extent that the corporation, under the LIFO method, disposes of that inventory within the 10-year recognition period.

There are several possible values from which the value used to measure the unrealized gain built into the value of inventory might have been selected: the expected sale price of the inventory when sold in the ordinary course of business less direct selling expenses (i.e., its “net realizable value”), the bulk sale price that could be expected if the corporation and its business were being liquidated, a multiplier of the adjusted basis using a historic markup on cost, etc. The measure of value

\textsuperscript{226}Reg. § 1.1374-7(b).

\textsuperscript{227}See Steven Dilley, Inventory Method May Dramatically Affect Section 1374 Built-In Gain Recognition, 58 Tax Notes (TA) 1789 (Mar. 29, 1993).

\textsuperscript{228}I.R.C. § 1363(d)(1). See infra Part VI (“BASIS ADJUSTMENTS TO LIFO INVENTORY”).
adopted by the regulations is the value that the inventory would have if all of the assets of the corporation were being acquired as a going concern by another company. More specifically, “fair market value” for this purpose is defined by Regulation section 1.1374-7(a) as “the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business.” (emphasis added).

In making this determination of value, the preamble to Regulation section 1.1374-7 suggests several factors that should be considered:

(1) the replacement cost of the inventory;

(2) the expected retail selling price of the inventory;

(3) the seller's incentive to demand a price for the inventory that would compensate for and provide a fair return for expenditures the seller incurred to obtain, prepare, carry, and dispose of the inventory before the sale of the business; and

(4) the buyer's incentive to pay a price for the inventory that would compensate for and provide a fair return for similar expenditures.229

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The preamble goes on to state that inventory value will “generally” be less than its anticipated retail price, but greater than its replacement cost.\textsuperscript{230}

As noted earlier, section 1363(d) has no effect on the converting corporation’s continued use of the LIFO method to account for its inventories.\textsuperscript{231} Regulation section 1.1374-7(b) provides that the inventory method used by an S corporation for tax purposes also must be used to identify whether inventory disposed of during the recognition period was held on the first day of that period.\textsuperscript{232} Consequently, an S corporation that continues to use the LIFO method after its conversion is not considered as having disposed of any of the LIFO inventory it

\textsuperscript{230}In the preamble to the proposed regulations, the Treasury suggested that it might adopt a safe harbor that could be used to value inventory in connection with S elections. The American Institute of Certified Public Accountants (AICPA) endorsed the idea and promised to submit a specific recommendation. \textit{AICPA Comments On Proposed Built-In Gains Tax Regs,} 93 Tax NOTES TODAY 91-38 (Apr. 27, 1993) (LEXIS, LPEDTAX lib., TNT file, elec. Cit 93 TNT 91-38). Ultimately, however, both the Treasury and the AICPA abandoned the idea of developing a formulaic approach to valuing inventory for this purpose.

In the only reported case involving inventory valuation for purposes of section 1374, the court rejected the taxpayer’s cost valuation and accepted the Service’s addition of a profit factor to the taxpayer’s work-in-progress inventory. Reliable Steel Fabricators, Inc. v. Commissioner, 69 T.C.M. (CCH) 3051, 1995 T.C.M. (RIA) ¶ 95,293.

\textsuperscript{231}See supra text accompanying note 9. Note, however, that in some nontaxable C-into-S carryover-basis transactions, Regulation section 1.381(c)(5)-1 may require the discontinuation of the LIFO method with respect to LIFO inventory acquired from the transferor C corporation. See supra note 64.

\textsuperscript{232}Note, however, that if a corporation changes its method of accounting for inventory (for example, from FIFO to LIFO with respect to appreciated inventory) immediately before or immediately after its conversion to S status, and if a principal purpose for that change is to avoid the section
held on the first day of the recognition period unless the
 carrying value of its inventory for a tax year during that ten-
 year period is less than the carrying value on the first day of
 the recognition period.233 This is true even though, as a
 practical matter, the corporation will have turned its physical
 inventory over many times.234

F. Net Operating Losses and Net Operating Loss Carryovers

1. In General.

Section 172(c) defines a “net operating loss” (NOL) as “the
excess of the deductions allowed by this chapter over the gross
income.” Although section 1363(d) provides special treatment for
the taxes that result from the recognition of the LRA, the gross
income resulting from the recognition of the LRA is treated like
any other ordinary gross income. Consequently, it seems clear
from the statute that any NOLs that the converting corporation
may have in the recognition year must first be used to offset

1374 built-in gains tax, it must use its former method to identify
dispositions of inventory. Reg. § 1.1374-7(b).

233In short, in order to have recognized built-in gain from disposition
of LIFO inventory, the converted corporation must invade (i.e., decrement) a
LIFO layer that was present on the first day of its first year as an S
corporation.

234See supra note 34.
the gross income recognized under section 1363(d), before any of these losses can be carried back to prior tax years.

Example 6:

L Corp, a calendar-year, LIFO-method C corporation, elected to be taxed as an S corporation effective for the first day of its 2006 calendar tax year. In 2005, L Corp sustained a NOL of $10M (computed without regard to the section 1363(d) inclusion) and recognized a section 1363(d) inclusion of $6M. L Corp recognized taxable income of over $10M in 2003 and 2004.

L Corp must first use the 2005 NOL to offset its $6M LRA before any balance can be carried back to generate a refund of taxes it paid on its 2003-2004 taxable income. L Corp does not have the option of carrying the entire $10M NOL back to generate an immediate refund, while paying the taxes resulting from the recognition of the $6M LRA in four installments under section 1363(d).\(^{235}\)

If the converting corporation has any NOL carryforwards to the recognition year, these losses can be used to offset the gross income recognized under section 1363(d).\(^{236}\) It seems clear that these losses will first be used to offset any non-LRA gross income (the tax on which does not qualify for installment payments and is not exempt from estimated taxes) and that only


\(^{236}\)Revenue Procedure 94-61, Q&A No. 5, 1994-2 C.B. 775, expressly states that the gross income recognized under section 1363(d) can be offset with NOL carryovers.
the excess loss carryovers, if any, will reduce the gross income resulting from the recognition of the LRA.\textsuperscript{237}

2. Post-conversion NOL Carrybacks.

As previously observed, a converted corporation cannot carry back a NOL arising in an S year, even where the NOL is attributable to the recognition of a built-in loss under section 1374.\textsuperscript{238} However, where the converting corporation is the transferor-distributing corporation in a section 368(a)(1)(D) and 355 corporate spin-off or split-off, that corporation may continue on as a C corporation.\textsuperscript{239} If it does and if, within the

\textsuperscript{237}Revenue Procedure 94-61, 1994-2 C.B. 775 does not expressly address the issue of how these losses are allocated between non-LRA and LRA income pools. To the author, it is clear from a reading of the statute that the tax on the income recognized under section 1363(d)(1) is the incremental tax that results from the inclusion of the LRA in the converting corporation’s gross income. Section 1363(d)(2)(A) reads “[a]ny increase in tax imposed by this chapter by reason of this section . . . .” (emphasis added). This amount is derived by computing tax liability first with, and then without, the LRA. See infra Part V.A. (“With’and ‘Without’ Calculations”). The effect of this calculation is that all expenses, losses, and loss carryovers first offset non-LRA gross income before they offset any of the gross income recognized under section 1363(d).

\textsuperscript{238}See supra note 15.

\textsuperscript{239}This would be the case where a C corporation transfers LIFO inventory to a new subsidiary, immediately distributes the stock of that subsidiary to one or more of its shareholders, and the new subsidiary makes an S election that is effective immediately upon its formation. In such case, the “converting corporation” is the transferor-distributing C corporation. It will recognize the LRA on its corporate tax return for the recognition year, and it will be required to pay the first installment of the resulting income taxes. The “converted corporation” will be the new transferee-distributed S corporation, and it will be responsible for the payment of the remaining
two years following the recognition year, it sustains a NOL, there is nothing in the Code, regulations, or legislative history that would suggest that that the corporation cannot carry its NOL back to offset the section 1363(d) inclusion that it reported as income in the recognition year.\textsuperscript{240}

3. **Consolidated Losses, Credits, and Carryovers.**

For its last taxable year as a C corporation, a converting corporation may have been a member of an affiliated group filing a consolidated tax return. This can happen where (1) an S

\textsuperscript{240}But which corporation, the converting corporation or the converted corporation, is entitled to the resulting refund? Presumably, the amount of each of the four required installment payments would be recomputed. As to the first installment, the difference between the amount originally paid by the converting corporation and the recomputed amount should undoubtedly be refunded to the converting corporation.

Less clear is whether the converting corporation or the converted corporation should get any refund due on account of the second, third, and fourth installments, each of which was actually paid (or payable) by the converted corporation. Despite the fact that (1) the income recognized under section 1363(d) was included in the taxable income of the converting corporation, and that (2) it was the converting corporation’s NOL that triggered the refund, the refund should probably be claimed by and paid to the converted corporation. This may be a matter of little significance where the two corporations are owned in the same proportions by the same shareholders (i.e., where the stock of the converted corporation’s had been distributed \textit{pro rata} to the shareholders of the converting corporation in a spin-off division). However, if the converted corporation’s stock had been distributed in a \textit{non-pro rata} split-off division, the converting corporation may prefer to elect to forego the carry back of its NOL (under section 172(b)(3)) to prevent the lion’s share (i.e., three-fourths) of the tax savings resulting from the deduction of its NOL from inuring to the benefit of the converted corporation’s shareholders.
election is made for the common parent of a consolidated group, (2) an S election is made for the common parent and a QSub election is simultaneously made for one or more subsidiaries in its consolidated group, (3) the stock of a subsidiary member is purchased by one or more eligible shareholders\textsuperscript{241} and the acquisition is immediately followed by an S election (or, where the purchaser is an S corporation and it acquires 100\% control of the acquired subsidiary, by a QSub election), (4) the assets of the common parent are acquired by an S corporation in a nontaxable carryover-basis transaction (followed, perhaps, by the acquiring S corporation’s QSub election for one or more of the acquired subsidiaries), or (5) the stock of a new or existing subsidiary is distributed by the parent to one or more of its shareholders who immediately elect S status for the distributed subsidiary, or its former parent, or both.

Section 1363(d)(4)(D) provides a special rule where the converting corporation is a member of consolidated group for its last taxable year as a C corporation. Under this provision, the converting corporation will not be treated as a member of the group with respect to the LRA that it is required to include in

\textsuperscript{241}Only individuals who are U.S citizens or residents, decedent’s estates, estates of individuals in bankruptcy, and certain trusts and tax-exempt organizations may own stock in S corporations. I.R.C. § 1361(b). As noted previously, a corporation that is wholly-owned by an S corporation may also qualify for S corporation treatment if its parent makes a QSub election under section 1361(b)(3). See supra note 63 and accompanying text.
its gross income under section 1363(d). Although the stated purpose for the enactment of this provision was to make the converting corporation, and not the consolidated group, liable for any tax attributable to the recognition of the LRA, the impact of the language chosen to manifest that purpose is much broader.

Since the section 1363(d) inclusion of a converting corporation that was a member of a consolidated group at the

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242 Section 1363(d)(4)(D) (added by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, and retroactively effective from the effective date of section 1363(d)) reads:

Not treated as member of affiliated group. Except as provided in regulations, the corporation referred to in paragraph (1) shall not be treated as a member of an affiliated group with respect to the amount included in gross income under paragraph (1).

This treatment is somewhat analogous to the treatment of a target corporation where a section 338(g) election is made following a qualified stock purchase, and the language used in section 1363(d)(4)(D) is similar to the language used in section 338(h)(9), which reads:

Target not treated as member of affiliated group. Except as otherwise provided in paragraph (10) or in regulations prescribed under this paragraph, the target corporation shall not be treated as a member of an affiliate group with respect to the sale described in subsection (a)(1).

Presumably, however, the converting corporation will, for the recognition year, still be treated as a “component member” of the controlled group under section 1563 for the purpose of applying the section 1561 limitations on certain tax benefits (for example, apportionment of taxable income brackets in applying the corporate tax rate).


It is intended that in the case of a converting corporation that was previously a member of an affiliated group filing a consolidated return, and whose last taxable year as a C corporation would for other purposes be its last taxable year as a member of the group, the converting corporation, and not the group of corporations with which it filed a consolidated return during its last year as a C corporation, would be liable for any tax attributable to the recognition of the LIFO recapture amount.
time of its conversion to S status is deemed to have been recognized by a nonmember, that income is isolated from the NOLs (and tax credits) and the NOL (and tax credit) carryovers of other members of the consolidated group. None of the losses or credits attributable to these other members may be used to reduce the amount of income or the amount of tax that results from the application of section 1363(d). Presumably, however, any portion of the group’s consolidated NOL (or tax credit) carryovers that are attributable to the converting corporation and that are not otherwise used against the group’s consolidated income (or tax liability) can be used by the converting corporation to offset the income (or tax liability) resulting from the recapture of its LRA.\textsuperscript{244}

If, for example, an eligible shareholder purchases all of the stock of a subsidiary member of a consolidated group from its common parent and immediately makes an S election (or, where the purchaser is an S corporation, a QSub election) that takes effect on the first day of the subsidiary’s first tax year

\textsuperscript{244}See Reg. § 1.1502-21(b)(2)(i). The amount of loss attributable to a member of a consolidated group is referred to as an “apportioned loss” and is determined under the rules set forth in Regulation section 1.1502-21T(b)(2)(iv).

Note that under Regulation section 1.1502-21(b)(2)(ii)(A), any loss carryforwards attributable to a corporation that ceases to be a member of the group must first be used to offset consolidated income for the year of departure before these losses can be carried to the departing member’s first separate return year. This rule requires that the converting corporation’s apportioned loss must be used to offset consolidated income before any
following its departure from the group, then, unless the stock purchase and sale are subject to a section 338(h)(10) election, (1) the income (and tax) resulting from the subsidiary’s recognition of its LRA under section 1363(d) cannot be reduced by the losses (and credits) attributable to other members of the group, and (2) each of the four installment payments of the incremental tax on that income must be paid by the converting corporation and not by the consolidated group of which it was formerly a subsidiary member.\textsuperscript{245} The selling group neither forfeits any of its favorable tax attributes that are attributable to its continuing members, nor has any liability for the payment of the incremental tax imposed on the departing member under section 1363(d). Consequently, to the extent not otherwise factored into the negotiated purchase price of the stock, it is the purchaser, not the seller, who will bear the full economic burden of the incremental tax on the section remaining balance becomes available to reduce the income triggered by section 1363(d).

\textsuperscript{245}Since the departing subsidiary corporation is not treated as a member of a consolidated group with respect to the section 1363(d) inclusion or the incremental taxes thereon, the selling parent corporation will not take these items into account in adjusting its basis in the departing subsidiary’s stock under Regulation section 1.1502-32 and Temporary Regulation section 1.1502-32T.

If the purchasing S corporation made a section 338(g) election with respect to the purchase of the subsidiary member, all of the gain or loss built into the value of all of the acquired C corporation’s assets (not just the LRA built into its LIFO inventories) would be recognized on a separate “one-day” C corporation tax return. I.R.C. § 338(h)(9); Conf.Rep. H.R. Rep. No. 97-986, at 22-1983 (1982), reprinted in 1982 U.S.C.C.A.N. 4203. Any resulting tax liability, even the taxes attributable to the acquired corporation’s
1363(d) inclusion. This is as it should be: it was the unilateral action of the purchaser in making the S election that triggered the acceleration of the recognition of the subsidiary’s LRA, and it is the purchaser, not the seller, who expects to benefit from that election.

But where 100% of the stock of a subsidiary member of a consolidated group is purchased by an S corporation and the S corporation immediately elects to treat the acquired C corporation as a QSub, section 1363(d), and therefore section 1363(d)(4)(D), will not apply if the buyer and the seller make a timely section 338(h)(10) election.246 Under section 338(h)(10), recognition of its LRA, would be payable at the normal time – no amount would qualify under section 1363(d)(2) for installment payment.

246S corporations are permitted to make section 338(g) and section 338(h)(10) elections where they otherwise meet the requirements of those respective provisions. H.R. Rep. No. 104-586, at 92; P.L.R. 92-45-004 (July 28, 1992). Prior to the issuance of Private Letter Ruling 92-45-004, the Service had taken the position that section 1371(a)(2) precluded S corporations from making section 338 elections. P.L.R. 88-18-049 (Feb. 10, 1988); I.R.C. § 1371(a)(2) (prior to its repeal in 1996, this subsection read: “For purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual.”).

Background. There are two elections available under section 338: section 338(g) and section 338(h)(10). Both require that the acquiring corporation acquire at least 80% control (as defined under section 1504(a)) of the target corporation in taxable purchases from unrelated parties within a period not exceeding 12 months. Both require that the election be made on or before the 15th day of the eight month following the end of the month in which the 80% acquisition threshold is first met. Generally stated, the effect of both elections is to treat the taxable stock sale as if it had been structured as a taxable asset sale, followed by the liquidation of the target corporation. In a section 338(g) election, this fiction is only applied to determine the target corporation’s tax consequences (i.e., the shareholders of the target corporation are taxed on the actual sale of their stock, not as if the target had sold its stock and then liquidated). A section 338(g) election is made unilaterally by the acquiring corporation.

In a section 338(h)(10) election, however, the stock purchase and sale is ignored by all parties, and both the buyer and the seller are taxed as if
the departing subsidiary is taxed as if it had sold all of its assets (not just its LIFO inventory) in a fully taxable transaction and had then liquidated into its parent under section 332. One of the many consequences of this election is that any income, gain, or loss resulting from the deemed asset sale is consolidated with the income, gain, and loss of the other group members in computing consolidated taxable income and consolidated tax liability.


Section 1363(d)(4)(D) does not apply where the parent of a consolidated group makes an S corporation election for itself and QSub elections for one or more of its subsidiaries that are all effective on the same day.247 The regulations treat the

247But see David A. Lifson, AICPA Voices Concerns About Regs on S Corporation Subs., 98 TAX NOTES (TA) 223-35 (Nov. 10, 1998), where the American Institute of Certified Public Accountants (AICPA) suggested that the then-proposed regulations (Proposed Regulation section 1.1361-4, 63 Fed. Reg. 19864 (1998)) be modified to explicitly state that section 1363(d)(4)(D) is
deemed liquidation of the subsidiary as having occurred while
the parent was still a C corporation (i.e., as of the close of
the day before the QSub election is effective and before the
parent’s S election becomes effective). The deemed liquidation
is generally nontaxable under sections 332 and 337 and does not
itself trigger the recognition of the subsidiary’s LRA. The
subsidiary’s basis in the LIFO inventory and its tax
attributes, including its LRA, are deemed to carry over to the
parent as of the close of the parent’s last day as a C
corporation, but immediately before the parent’s S election
becomes effective. The parent corporation will therefore be
required to recognize the LRA of any LIFO inventory it holds
directly and the LRA of each of the subsidiaries for which it
makes a QSub election. Since all of the current and carryforward
losses and credits attributable to the QSub(s) carry over and
merge with those of the parent immediately before the LRA is
triggered into income, these combined losses and credits can

\[\text{inapplicable to simultaneous S and QSub elections made by the parent of a}
\text{consolidated group. No such language was incorporated into the final}
\text{regulations.}\]

\[\text{Reg. § 1.1361-4(b)(1), -4(d).}\]

\[\text{These liquidations are generally governed by section 332 (no gain or}
\text{loss is recognized by the parent), section 337 (no gain or loss is recognized}
\text{by the liquidating subsidiary), and section 381 (tax attributes of the}
\text{liquidating subsidiary generally carry over to the parent).}\]

\[\text{The subsidiary’s bases in its assets generally carry over to the}
\text{parent under section 334(b).}\]

\[\text{I.R.C. § 381(a)(1), (c)(5).}\]
offset the combined section 1363(d) inclusions without regard to
the limitations otherwise imposed by section 1363(d)(4)(D).

Section 1363(d)(4)(D) should likewise be inapplicable where an S corporation acquires either (1) 100% of the stock of the
common parent of a consolidated group,252 or (2) the assets of the common parent corporation in a nontaxable Type A, Type C, or
Type D reorganization,253 and the acquiring S corporation immediately makes QSub elections for the acquired parent
corporation (in a stock acquisition) and for its subsidiaries.

5. Conversion of the Common Parent: C Corporation

Subsidiaries Remain.

Where the converting corporation is the common parent of a consolidated group and a QSub election is not simultaneously
made with respect to one or more of its subsidiary members, does section 1363(d)(4)(D) apply to prevent the current and

252 Where the stock of the parent corporation is acquired in a stock-for-
stock exchange that would otherwise meet the requirements of section
368(a)(1)(B) (Type B reorganization) and, as part of the plan, the acquiring
S corporation makes an immediate QSub election for the acquired parent, the
regulations apply the step transaction doctrine to treat the transaction as
an acquisition of the parent’s assets (which may qualify under section
368(a)(1)(C) or (D) if the requirements of either of those provisions are

As previously noted, section 1363(d) is inapplicable where an S
corporation acquires 80% or more of the stock of a common parent corporation
in a qualified stock purchase and elects to treat the stock purchase as an
asset purchase under section 338(g). See supra note 245.

253 I.R.C. § 368(a)(1)(A), (C), (D).
carryforward losses and credits attributable to its continuing C corporation subsidiaries from offsetting the parent’s section 1363(d) inclusion on its final C corporation consolidated return? Unfortunately, section 1363(d)(4)(D) does not provide an exception where the converting corporation is the common parent of the group. Nor has the Treasury issued any regulations that address this issue.

In the author’s opinion, the Treasury should issue regulations similar to those set forth in Regulation sections 1.338-10(a)(1) and (4). In an analogous situation that raises the same fundamental issue, these regulations provide an exception to the separate-return treatment otherwise mandated under section 338(h)(9) where the common parent of a consolidated group is acquired in a stock purchase and the acquisition is subject to a section 338(g) election. These regulations permit the common parent target corporation and its subsidiary members to recognize their respective section 338 gains and losses on a consolidated return. These regulations also permit two or more members of the seller’s consolidated group that are acquired at the same time by the same purchaser to file a “combined deemed sale return.”

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254 See also I.R.C. § 338(h)(15) (“Combined deemed sale return”).
V. CALCULATION AND PAYMENT

The section 1363(d) inclusion is generally reported as income on the converting corporation’s final C corporation tax return. This is true not only where the event that triggered the application of section 1363(d) is the converting corporation’s S election, but also where the converting corporation has been acquired by an S corporation in a nontaxable carryover-basis transaction, where the stock of an existing C corporation is distributed by its parent in a nontaxable section 355 distribution and the distributed corporation makes an S election, and where the converting corporation is an existing C corporation subsidiary of an existing S corporation that elects to treat that subsidiary as a QSub.

Where (1) a C corporation transfers LIFO inventory to a new subsidiary under section 368(a)(1)(D) and immediately distributes the stock of that subsidiary to its shareholders under section 355, and (2) the distributed corporation makes an S election that takes effect from the date of its formation, it will be the transferor-distributing corporation, not the

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255Where a C corporation transfers its assets to an S corporation in a nontaxable Type A or Type C reorganization, in an acquisitive Type D or Type G reorganization, or in a section 332 liquidation, the transferor corporation’s tax year closes as of the date of the transfer. I.R.C. § 381(b)(1), (2). The transferor corporation’s tax year does not close, however, where the transfer is incident to a Type F reorganization. I.R.C. § 381(b).
transferee-distributed S corporation, that will include the LRA in its gross income for its tax year in which the distribution was made. Similarly, where a QSub election is made with respect to a LIFO-method C corporation subsidiary and its C corporation parent simultaneously makes an S election, the subsidiary’s LRA will be reported on the parent corporation’s final C corporation return.

A. "With" and "Without" Calculations

The section 1363(d) inclusion is taken into account in computing all "Chapter 1" taxes, including the alternative minimum tax. In this respect, the section 1363(d) inclusion is treated no differently than any of the converting corporation’s other ordinary gross income. What makes the section 1363(d) inclusion unique is the fact that the incremental tax attributable to this amount is payable in four interest-free

256Reg. § 1.1363-2(a)(2).

257See supra Part IV.F.4. ("Conversion of the Common Parent: Effect of Simultaneous QSub Election For Subsidiary Member").

258As previously observed, however, many C corporations are exempt from the AMT under the small corporation exemption of section 55(e). See supra note 136.

The section 1363(d) inclusion is apparently also taken into account for the purposes of applying the personal holding company tax (sections 541-547) and the accumulated earnings tax (sections 531-537).

259But see supra Part IV.F.3. ("Consolidated Losses, Credits, and Carryover").
annual installments and that these installments are not subject to estimated taxes.\textsuperscript{260}

To determine the incremental amount of tax that is attributable to the section 1363(d) inclusion (incremental tax), the converting corporation must compare (1) its actual tax liability with the section 1363(d) inclusion with (2) the amount of tax that would have been due without the section 1363(d) inclusion.\textsuperscript{261} In making the without calculations, the corporation must take into account all items affected by a taxable income limit, the alternative minimum tax, the foreign tax credit, etc. The incremental tax is the excess of the with tax liability, if any, over the without tax liability.\textsuperscript{262}

\textsuperscript{260}See infra Part V.D. ("Payment of the Incremental Tax").

\textsuperscript{261}This approach is implied by section 1363(d)(2)(A), which defines the amount qualifying for installment payments as “[a]ny increase in the tax imposed by this chapter by reason of this subsection. . . .” Chapter 1 includes sections 1 through 1399. This approach was expressly adopted by the Service in Announcement 88-60, 1988-15 I.R.B. 47:

To determine the additional tax due to LIFO recapture, the corporation must complete lines 1 through 9b of Schedule J of the Form 1120 based on income which includes the LIFO recapture amount. On a separate worksheet, using the Schedule J format, the corporation must then complete the entire worksheet (lines 1 through 10) based on taxable income which excludes the LIFO recapture amount. (For this purpose, the exclusion of the LIFO recapture amount may cause certain items, such as the foreign tax credit, to be recalculated.) The total of lines 1 through 9b of Schedule J must then be compared to line 10 of the worksheet. The difference is the additional tax due to LIFO recapture.

\textsuperscript{262}The LRA is reported as “Other Income” on Line 10 of Form 1120. The deferred amount of the incremental tax liability is subtracted from the total for Line 11 of Schedule J ("Total Tax"). 2004 Instructions for Forms 1120 and 1120-A, pp. 11, 22-23. The S corporation reports each of the remaining installments on Line 22c of Form 1120-S. See 2004 Instructions for Forms 1120-S, p. 18.
B. Alternative Minimum Tax

As noted above, to determine the incremental tax for the recognition year, the converting corporation must also determine its tentative minimum tax with and without the section 1363(d) inclusion. In making the without computations, the section 1363(d) inclusion is ignored in computing both the corporation’s pre-adjustment AMTI and the ending LRA used to compute its ACE adjustment. Conversely, in making the with calculations, the section 1363(d) inclusion should be reflected in the corporation’s pre-adjustment AMTI and its ending LRA should be reduced to zero.263

The recognition of the LRA under section 1363(d) will seldom, if ever, give rise to an AMT liability for the converting corporation. But it may permit the converted corporation to use some or all of any AMT credit carryforwards that it might have to reduce any regular tax liability resulting from the application of section 1374.264

263 All Code provisions that apply in determining regular taxable income, including section 1363(d), also apply in determining AMTI. I.R.C. § 55(b)(2); Reg. § 1.55-1(a).

264 Any minimum tax credit carryforwards that cannot be used to reduce the converting corporation’s tax liability on its last C corporation return can be carried forward into its S years and reduce any regular income taxes that might otherwise be due on its net recognized built-in gains under section 1374. I.R.C. § 1374(b)(3)(B). See supra note 15.
1. **Background**

A C corporation’s ultimate income tax liability for any taxable year will be the greater of its regular tax or its “tentative minimum tax.” The corporation’s “tentative minimum tax” is 20% of the excess of its AMTI over the exemption amount \(^{265}\) less the AMT foreign tax credit.\(^{266}\) If the corporation’s tentative minimum tax is greater than the regular tax, the corporation’s tax liability for the year is its tentative minimum tax. If its regular tax is the greater of these two amounts, then the corporation’s tax liability for the year is the regular tax, but this amount may be reduced down to, but not below, its tentative minimum tax liability for the year if and to the extent that the corporation has any AMT credit carryforwards.\(^ {267}\)

\(^{265}\)The exemption amount for corporations is $40,000. I.R.C. § 55(d)(2). The exemption is reduced by 25% of the amount by which AMTI exceeds $150,000, but the exemption cannot be reduced below zero. I.R.C. § 55(d)(3)(A). The exemption amount is completely phased out when AMTI is $310,000 or more.

\(^{266}\)I.R.C. § 55.

\(^{267}\)In a subsequent year in which the regular tax applies, section 53 allows the corporation to claim a credit for any uncredited “adjusted net minimum taxes” that it paid in prior tax years. For a C corporation, the “adjusted net minimum tax” is the tentative minimum tax for the year reduced by the regular tax for that year (i.e., the additional tax imposed under section 55). The amount that the corporation can credit in a carry-forward tax year is limited to the excess of the regular tax liability over the tentative minimum tax for that year. I.R.C. § 53(c). Minimum tax credits cannot be carried back, but they can be carried forward indefinitely. The credit available for use in any carry-forward year is the sum of the adjusted
The starting point in computing AMTI is regular taxable income. This amount is then adjusted to eliminate many of the tax preferences and deferrals that cause taxable income to diverge from economic income.\textsuperscript{268} For taxable years beginning after 1989, one of the adjustments that a C corporation makes in determining its AMTI is for “adjusted current earnings” (ACE). ACE is the corporation’s pre-adjustment AMTI\textsuperscript{269} plus or minus the adjustments listed in section 56(g) – adjustments which closely resemble those made to regular taxable income in deriving current E&P (but without taking into account U.S. federal income taxes, credited foreign income taxes, or dividend distributions).\textsuperscript{270} Where a corporation's ACE exceeds its pre-adjustment AMTI, pre-adjustment AMTI is increased by 75% of the excess.\textsuperscript{271} Conversely, where the pre-adjustment AMTI exceeds ACE, pre-adjustment AMTI is decreased by 75% of the excess (but this negative ACE adjustment cannot exceed the amount required to net minimum taxes for all prior taxable years beginning after 1986, less the sum of the minimum tax credits allowed in these prior years).

\textsuperscript{268}I.R.C. §§ 56-58.

\textsuperscript{269}“Pre-adjustment AMTI” is AMTI determined before taking into account the ACE adjustment itself or the alternative tax net operating loss deduction.

\textsuperscript{270}See Reg. § 1.56(g)-1(a)(5)(i) (all rules applicable in determining regular taxable income also apply in determining ACE unless otherwise modified by the AMT or ACE rules).

\textsuperscript{271}I.R.C. § 56(g)(1).
reduce the net cumulative positive ACE adjustments previously recognized by the corporation in computing AMTI to zero).\textsuperscript{272}

2. LRA Adjustment to ACE

One of the adjustments that a corporation is required to make in computing ACE is the annual increase or decrease in its LRA.\textsuperscript{273} Generally speaking, the effect of this adjustment is to put the corporation on a FIFO basis for ACE purposes. Consequently, as of the beginning of the recognition year, most or all of the net cumulative amount of all post-1989 changes in the converting corporation’s LRA will have already been reflected in its ACE.

In making the without calculations, the converting corporation’s ACE adjustment for any positive or negative change in its LRA from the preceding year will be made in the normal manner. In making the with calculation, the converting corporation will make a negative ACE adjustment to reflect the

\textsuperscript{272}I.R.C. § 56(g)(2). Pre-adjustment AMTI is also reduced by the corporation’s AMT NOL carryovers.

\textsuperscript{273}I.R.C. §§ 56(g)(4)(D)(iii), 312(n)(4) (adjustment applies only with respect to taxable years beginning after December 31, 1989). See also Reg. § 1.56(g)-1(f)(3). If the corporation’s LRA is larger at the end of the current year than it was at the end of the preceding year, the difference increases ACE; if it is smaller, the difference reduces ACE. Although the LRA cannot be negative, negative LRA adjustments reduce ACE even where these adjustments exceed the cumulative net positive LRA adjustments (if any) made in computing ACE in prior years. Reg. § 1.56(g)(1)(f)(3)(v), Ex. (l). This can happen where the corporation’s current ending LRA drops below the LRA it had as of the end of its last tax year beginning before January 1, 1990.
fact that the recognition of the LRA under section 1363(d) has the collateral effect of reducing the LRA to zero. This adjustment may permit the converting corporation to utilize some or all of any AMT credit that it has carried forward to the recognition year.

Example 7:

Z Corp, a calendar-year LIFO-method C corporation, was formed on January 1, 1989. It converted to S status effective January 1, 2007. At that time, its LRA was $12,000,000. Its inventory amounts computed under LIFO and FIFO are the same for regular tax and AMT purposes. Its regular taxable income in each year (1990 through 2006) was $100,000 (before taking into account the $12,000,000 section 1363(d) inclusion it recognized in 2006) and the only difference between its regular taxable income and AMTI or between AMTI and ACE is the annual change in Z Corp’s LRA. The corporate tax rate is a flat 35% for regular tax purposes and 20% for AMT.

After taking into account the interaction between the regular tax and the alternative minimum tax, the recognition of Z Corp’s $12,000,000 LRA in 2006 will trigger an incremental tax liability of $2,805,000.

---

274 Since post-1989 net increases in the converting corporation’s LRA will have increased its ACE (and, therefore, its AMTI) in prior years, the negative adjustment that results from reducing the LRA to zero in the recognition year is necessary in order to prevent double counting. For a converting corporation that was formed and that adopted LIFO prior to 1990, this negative adjustment is not limited to the cumulative net increases that were previously recognized in computing the corporation’s annual ACE adjustments. See supra note 273. Consequently, the negative adjustment to ACE (in making the with calculations) will include any remaining balance of the LRA built into the converting corporation’s LIFO inventory as of the beginning of its first post-1989 tax year.

275 Either because there simply are no differences in the amounts used to compute inventory values for regular tax and AMT purposes, or because the corporation made an election to use its regular-tax inventory values to compute its inventory values and cost of goods sold. See discussion supra Part IV.A.1. (“Calculating the LRA for Alternative Minimum Tax Purposes).
Figure 3 (numbers are in thousands) sets forth the details of the required calculations.
### Figure 3
(000s omitted)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Without Section 1363(d)(1)</td>
<td>With Section 1363(d)(1)</td>
</tr>
<tr>
<td>FIFO Inventory Value</td>
<td>$3,200</td>
<td>$15,000</td>
<td>$17,000</td>
</tr>
<tr>
<td>LIFO Inventory Value</td>
<td>$2,200</td>
<td>$4,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>LIFO Recapture Amount</td>
<td>$1,000</td>
<td>$11,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Change in LRA From Preceding Year</td>
<td>n/a</td>
<td>$10,000</td>
<td>$1,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(11,000)</td>
</tr>
<tr>
<td>Regular Taxable Income</td>
<td>$-</td>
<td>$1,600</td>
<td>$100</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>12,100</td>
</tr>
<tr>
<td>Regular Tax (35%)</td>
<td>$-</td>
<td>$560</td>
<td>$35</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>4,235</td>
</tr>
<tr>
<td>Pre-Adjustment AMTI&lt;sup&gt;b&lt;/sup&gt;</td>
<td>$-</td>
<td>$1,600</td>
<td>$100</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>12,100</td>
</tr>
<tr>
<td>ACE&lt;sup&gt;c&lt;/sup&gt;</td>
<td>$-</td>
<td>$11,600</td>
<td>$1,100</td>
</tr>
<tr>
<td>ACE Adjustment&lt;sup&gt;d&lt;/sup&gt;</td>
<td>$-</td>
<td>$7,500</td>
<td>$750</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(7,500)</td>
</tr>
<tr>
<td>Post-Adjustment AMTI&lt;sup&gt;e&lt;/sup&gt;</td>
<td>$-</td>
<td>$9,100</td>
<td>$850</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>4,600</td>
</tr>
<tr>
<td>Tentative AMT (20%)</td>
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<td>$1,820</td>
<td>$170</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>920</td>
</tr>
<tr>
<td>Tax Liability (Before AMT Credit)&lt;sup&gt;f&lt;/sup&gt;</td>
<td>$-</td>
<td>$1,820</td>
<td>$170</td>
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<td></td>
<td></td>
<td></td>
<td>4,235</td>
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<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1,260</td>
</tr>
<tr>
<td>Tax Liability</td>
<td>$-</td>
<td>$1,820</td>
<td>$170</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2,975</td>
</tr>
<tr>
<td>Adjusted Net Minimum Tax&lt;sup&gt;g&lt;/sup&gt;</td>
<td>$-</td>
<td>$1,260</td>
<td>-</td>
</tr>
<tr>
<td>Total AMT Credit Carryforward</td>
<td>$-</td>
<td>$1,260</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>-</td>
</tr>
</tbody>
</table>

### Tax Liability Qualifying for Installment Payments under Section 1363(d)(2)(A):

- **Annual Installment:** $701<sup>k</sup>
- **Tax Due on Z Corp's 2006 Form 1120 (Final C Corporation Return):** $871<sup>l</sup>

<sup>a</sup> The ACE adjustment is required for tax years beginning after December 31, 1989.

<sup>b</sup> Since Z Corp has no other tax preference items, Pre-Adjustment AMTI equals Regular Taxable Income.

<sup>c</sup> Pre-Adjustment AMTI plus/minus the change in LRA from the preceding year.

<sup>d</sup> 75% of the difference between Pre-Adjustment AMTI and ACE. Negative ACE adjustment cannot exceed cumulative net positive ACE adjustments.

<sup>e</sup> Pre-Adjustment AMTI plus/minus the ACE adjustment.

<sup>f</sup> Greater of Regular Tax or Tentative AMT.

<sup>g</sup> Excess of the Tentative AMT over the Regular Tax.

<sup>h</sup> $12,000 + $100 = $12,100

<sup>i</sup> Lesser of $8,250 (75% x ($1,100-$12,100)) or $7,500 (cumulative net positive ACE adjustments for prior years)

<sup>l</sup> $2,805 - $170 = $2,805

<sup>k</sup> $2,805/4 = $701.25

<sup>l</sup> $170 + $701.25 = $871.25

### C. Short Period
Where the recognition year is a short taxable year that results from a change in the converting corporation’s accounting period under section 442, the converting corporation will generally be required to “annualize” its income to determine its with and without tax liabilities for the recognition year.

Under the general rule of section 443(b)(1), the converting corporation’s tax liability for the short period would be determined by (1) multiplying its taxable income for that period by 12 over the number of months in the short period,

---

276 A C corporation that attempts to make an S corporation election for the taxable year immediately following the short period will generally qualify for the automatic approval procedures for corporations changing accounting periods if the change is to a “permitted tax year.” Rev. Proc. 2002-37, § 4.02(6), 2002-1 C.B. 1030. A “permitted taxable year” of an electing S corporation is (1) the required taxable year (generally a calendar year), (2) a taxable year elected under section 444, (3) a “natural business year” that satisfies the 25% gross receipts test described in section 5.06 of this revenue procedure, (4) the “ownership taxable year”, or (5) a “52/53-week” taxable year that references the required taxable year, taxable year elected under section 444, natural business year, or ownership taxable year. Id.

277 Annualization is not required where the short taxable year is the result of the taxpayer’s not having been in existence for the full year. Consequently, income recognized during a short taxable year that results from the formation or liquidation of a corporation or from the application of section 381(b)(1) and (2) (see supra note 132) is not subject to the annualization requirement of section 443(b).

Additionally, although a corporation is required to close its tax year as of the end of the day that it joins (or leaves) a consolidated group, annualization is not required for either the short tax year preceding (or following) the corporation’s membership in the group or the short period that is included in the group’s consolidated return for the first (or last) year in which it was a member of the group. Reg. § 1.1502-76(b)(1), -76(b)(2)(i).

A short taxable year is counted as a full year for the purpose of determining the number of years to which NOLs can be carried. Reg. § 1.172-4(a)(2).

278 In computing taxable income for short year, deductions for NOL and capital loss carryovers from prior or subsequent tax years are taken into
(2) computing the tax on that amount using the graduated tax rates of section 11(b), and then (3) multiplying that amount of tax on the annualized income by the reciprocal of the fraction used to annualize the short period income.\textsuperscript{279}

Annualizing the taxable income of a converting corporation for a short recognition year can result in an inordinately large tax liability where the corporation’s section 1363(d) inclusion is substantial,\textsuperscript{280} but relief is generally available to taxpayers under section 443(b)(2). Under section 433(b)(2)’s alternative computation, the taxpayer’s tax liability for the short period, if lower than the tax computed under the general rule, will be the greater of (1) the tax for the short period without annualizing taxable income or (2) the tax for the 12-month period beginning on the first day of the short period, multiplied by a fraction, the numerator or which is the short

\textsuperscript{279}AMTI for the short period must also be annualized. I.R.C. § 443(d). Annualization is not required in computing the accumulated earnings tax (section 536) or the personal holding company tax (section 546).

\textsuperscript{280}Even before it is annualized, the section 1363(d) inclusion already bunches several years’ (or decades’) increases in the converting corporation’s LIFO reserve into a single tax year. The fact that section 1363(d) already bunches income accruing over several years does not negate, or in any way moderate, the annualization requirement. For an analogous situation, see Politte v. Commissioner, 101 T.C. 359 (1993) (guaranteed payments included in a partner’s short tax year return were required to be annualized under section 443(b)(1) even though the amount recognized in the short period was income for a 12 month period).

Annualizing the section 1363(d) inclusion can greatly exacerbate this bunching effect: the annualized amount of a $1 million section 1363(d) inclusion on a one-month short-period return would be $12 million.
period income, and the denominator of which is the income for the hypothetical 12-month period.\textsuperscript{281}

Although there is no authority directly on point, the fact that the income for the portion of the 12-month period following the end of the converting corporation’s short recognition year will not be subject to corporate-level taxes should not, in the author’s opinion, prevent the converting corporation from availing itself of the relief provided under this alternative method.\textsuperscript{282}

D. Payment of the Incremental Tax

1. In General

\textsuperscript{281}This relief provision is not automatic. The taxpayer must first prepare its return and pay the tax for the short period using the annualization method described in the preceding paragraph of the text. This optional method is available only on a claim for credit or refund, filed no later than the due date (including extensions) of taxpayer's return for the first tax year that ends on or after the day that is 12 months after the first day of the short period. I.R.C. § 443(b)(2)(A), (C); Reg. § 1.443-1(b)(2)(v)(a).

\textsuperscript{282}In another context, the Service and the Fourth Circuit Court of Appeals both held that the fact that the income of an S corporation was not subject to corporate-level taxes did not mean that the corporation did not have taxable income. In the first year following the revocation of its S election, a C corporation was permitted to apply corporate tax rates to the taxable income it reported on its Form 1120S for the preceding year in applying the exception provided under pre-1988 section 6655(b) to compute its estimated tax penalty. Rev. Rul. 72-388, 1972-2 C.B. 643; The Pants Rack, Inc. v. United States, 669 F.2d 198 (4th Cir. 1982).
The incremental tax is payable in four equal interest-free installments. The first installment must be paid by the converting corporation on or before the unextended due date for its tax return for the recognition year. The three succeeding installments are due on or before the unextended due date for the tax returns of the converted corporation for the three succeeding taxable years. Neither the first installment nor any of the subsequent installments is subject to estimated taxes under section 6655.

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283 I.R.C. § 1363(d)(2)(A); Reg. § 1.1363-2(d). Neither the number of installments nor the period for their payment is reduced where the converting corporation has used the LIFO method (or has been in existence) for less than four years as of the date that section 1363(d) applies. Rev. Proc. 94-61, Q&A No. 6, 1994-2 C.B. 775.

284 i.e., the converting corporation itself following its S election, or, following a nontaxable carryover-basis transaction, the transferee S corporation. Where an existing S corporation makes a QSub election for a C corporation subsidiary, the “converted corporation” is the parent S corporation.

285 I.R.C. § 1363(d)(2)(B); Reg. § 1.1363-2(d). Where the event that triggers the application of section 1363(d) is the disposition of a C corporation’s LIFO inventory to an S corporation in a nontaxable carryover-basis transaction, Regulation section 1.1363-2(d)(2) divides the liability for the payment of the four installments between the transferor C corporation and the transferee S corporation.

The three-year period between the due dates for the first and last installment payments may be shortened where the converted corporation’s first year as an S corporation is a short tax year, or where the converting corporation has transferred its assets in a nontaxable carryover-basis transaction to an S Corporation other than on the last day of the transferee S corporation’s tax year. (In a nondivisive nontaxable carryover-basis transaction, the transferor corporation’s tax year closes as of the end of the day of the transfer. See supra note 255. Thus, if, for example, a calendar-year LIFO-method C corporation merges into a calendar-year S corporation on November 30 in a nontaxable Type A reorganization, the period between the due dates for the first and second installments will only be one month.)

If the converted corporation liquidates prior to the payment of the final installment, all remaining installments become due and payable on the due date for the converted corporation’s final return.\textsuperscript{287} This rule would undoubtedly apply to the deemed liquidation of the converted corporation that results when a subsequent sale of its stock is subject to an election under either under section 338(g) or 338(h)(10).\textsuperscript{288} But what happens where the liquidation is incident to a nontaxable disposition of the converted corporation’s assets in a carryover-basis transaction to which section 381 applies? Does the unpaid tax become a liability of the transferee corporation, or do the remaining installments become due immediately upon the liquidation of the converted corporation? Revenue Procedure 1994-61, 1994-2 C.B. 775 does not expressly address this issue. A reasonable approach, but one for which there is scant authoritative support, would be to allow this liability to carry over from the converted corporation to the transferee corporation and to allow the remaining installments to be paid on schedule by the transferee C or S corporation.\textsuperscript{289}

\textsuperscript{287}Rev. Proc. 94-61, Q&A No. 8, 1994-2 C.B. 775.
\textsuperscript{288}See supra note 246.
\textsuperscript{289}Section 381(c) does not list these unpaid installment obligations as attributes that carry over to a transferee corporation following a nontaxable asset acquisition described in section 381(a). Where a tax attribute is not listed in section 381(c), there is uncertainty as to whether and when these attributes should be carried over to a transferee corporation. One view, expressly rejected in the regulations, is that carry over of all unlisted
Finally, there is nothing in the Code, the regulations, or Revenue Procedure 1994-61 that suggests that the due dates for any remaining installments must be accelerated where, prior to their payment, the converted corporation discontinues its use of the LIFO method, or where its S election is revoked or terminated.\textsuperscript{290}

2. Interest and Penalties

No interest is payable with regard to a section 1363(d) installment payment that is paid by its due date.\textsuperscript{291} Under Notice 2003-4, 2003-1 C.B. 294, if the converting corporation fails to include the LRA in the computation of its gross income, it may be liable for a 20\% accuracy-related penalty under section 6662. If the converting corporation (or its successor) fails to make an installment payment by its required due date, it may be

\textsuperscript{290} Since the termination of an S election does not change the reporting entity, there is no technical or policy basis for requiring acceleration of the unpaid installments. Instead, the continuing C corporation should remit such payments with its Form 1120 on or before the normal due date.

\textsuperscript{291} I.R.C. § 1363(d) (2) (C).
liable for a failure-to-pay penalty under section 6651 and for interest under section 6601. However, neither the failure to pay nor the late payment of a required installment will trigger an acceleration of any remaining unpaid installments.

3. Subsequent Termination of S Election

Neither the Code nor the regulations allow for a refund of all or any part of the section 1363(d) tax, or for an abatement of any outstanding installments, where a converted corporation subsequently loses or otherwise terminates its S election.

Example 8:

X Corp is a LIFO-method, calendar-year C corporation that makes an S election effective as of January 1, 2006. As of December 31, 2005, the LIFO basis and FIFO value of X Corp’s LIFO inventory are $15M and $25M, respectively. It computed an incremental tax of $3.5M on its $10M LRA and increased its LIFO basis to $25M.

X Corp’s LRA increased throughout the time it operated as an S corporation. As of January 1, 2007, at a time when its LIFO inventory had LIFO basis and FIFO values of $25M and $28M, respectively, X Corp’s S election terminated.

But for section 1363(d), the entire $10M LRA that had accrued as of the date of X Corp’s prior conversion to S status would have been re-immersed in

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292 Interest on the unpaid amount accrues from the last date prescribed for payment to the date it is actually paid, without regard to any extension of time for either the payment or the filing of the required income tax return. I.R.C. § 6601(a), (b).

293 The authority granted to the Service under section 6159(b)(4) to alter an installment agreement on a taxpayer’s failure to make a timely payment is limited to the specific installment payments described in that section and does not apply to installment payments under section 1363(d)(2).
C corporation solution when its S election terminated. In the final analysis, none of X Corp’s pre-election LRA would have escaped corporation-level taxation as a result of its S election, and the tax avoidance potential that inspired the enactment of section 1363(d) would have evaporated the moment X Corp reverted to back to C status.

In the author’s opinion, section 1363(d), if not repealed, should be modified to permit a converted corporation that subsequently revokes or otherwise loses its S election (i.e., ceases to qualify under section 1361, merges into a C corporation in a nontaxable section 368 reorganization, etc.) to obtain a refund (and an abatement of outstanding installments) of any section 1363(d) incremental tax attributable to any of the recapture-date LRA that is still built into its LIFO inventory as of the date of its reversion to C status – at least where that reversion occurs within a few years following the recognition year.

VI. BASIS ADJUSTMENTS TO LIFO INVENTORY

A. In General

\[294\text{See infra Part VIII ("CONCLUSION").}\]

\[295\text{This would, of course, also require that the corporation reverse all or a portion of the basis adjustment it had previously made to its LIFO inventory under section 1363(d)(1). The repeal of section 1363(d) (in favor of taxing post-conversion liquidations of a corporation’s pre-conversion LIFO reserves under section 1374) would eliminate this problem.}\]
In order to prevent the income recognized under section 1363(d) from being recognized a second time when the inventory is subsequently disposed of in a taxable transaction, the Code and the regulations require a converting corporation to make “appropriate adjustments” to the tax basis of its LIFO inventory.\(^{296}\) Neither authority, however, describes how the amount of the adjustment is to be calculated, how this amount is to be allocated to the inventory’s LIFO layers, or, where the corporation uses the dollar-value LIFO method, how the adjustment will affect the computation of the LIFO indexes used in making subsequent LIFO calculations.

Revenue Procedure 1994-61, 1994-2 C.B. 775, however, does address these issues with regard to LIFO inventory held directly (rather than through a lookthrough partnership interest) by the converting corporation. The amount of the adjustment in such cases is the amount of the LRA recognized as gross income under section 1363(d), without regard to any of the corporation’s current losses or NOL carryovers that may have been used to reduce the amount of this income that was actually taxed.\(^{297}\) According to the Service, there is only one appropriate method for allocating these adjustments to the LIFO inventory. That

\(^{296}\)I.R.C. § 1363(d)(1); Reg. § 1.1363-2(e)(1). See also Reg. § 1.1363-2(e)(2), and infra Part VI.B. ("LIFO Inventory Held Indirectly Through a Partnership") (discussion of elective adjustments to LIFO inventory held by a partnership in which the converting corporation holds an interest).
method is to collapse (i.e., combine) all of the LIFO layers into a single layer and to add the LRA to the LIFO value of the ending inventory as of the recapture date.\textsuperscript{298}

Example 9:\textsuperscript{299}

Assume that calendar-year X Corp adopted the dollar-value LIFO method for 2002 and that its LIFO inventory was comprised of the following layers as of December 31, 2005:

<table>
<thead>
<tr>
<th>Date</th>
<th>Base-Year Cost</th>
<th>LIFO Index</th>
<th>LIFO Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/01 Base Layer</td>
<td>$1,000</td>
<td>100%</td>
<td>$1,000</td>
</tr>
<tr>
<td>12/31/01 Layer</td>
<td>200</td>
<td>110%</td>
<td>220</td>
</tr>
<tr>
<td>12/31/02 Layer*</td>
<td>0</td>
<td>115%</td>
<td>0</td>
</tr>
<tr>
<td>12/31/03 Layer</td>
<td>100</td>
<td>120%</td>
<td>120</td>
</tr>
<tr>
<td>12/31/04 Layer</td>
<td>200</td>
<td>130%</td>
<td>260</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,500</td>
<td></td>
<td>$1,600</td>
</tr>
</tbody>
</table>

* The corporation experienced a "decrement" for the year ending 12/31/02, when the ending inventory (at base-year cost) was less than the beginning inventory (at base-year cost).

X Corp elected S status effective as of January 1, 2006, and the FIFO-LCM value of its inventory as of December 31, 2005, was $1,900.

\textsuperscript{297}Rev. Proc. 94-61, Q&A No. 5, 1994-2 C.B. 775.

\textsuperscript{298}Other systematic, if not theoretically sound, approaches would be to allocate the adjustment between the layers based on their relative LIFO carrying values or as a function of the annual increases in the LRA. See e.g., David H. Helmer, New Revenue Procedure on LIFO Recapture Yields Unexpected Result, 26 T AX ADVISER 27, 27-28 (Jan. 1995); see also Howard A. Stone, Treatment of LIFO Inventory Reserve When Converting From C to S Status, 22 TAX ADVISER 646, 646-647 (Oct. 1991).

Note that for corporations that experienced a decrease in their LIFO inventory for a tax year ending before September 19, 1994 (the date the revenue procedure was issued), the Service accepted “any reasonable method” used to allocate the LIFO recapture amount. Rev. Proc. 94-61, Q&A No. 2, 1994-2 C.B. 775. Otherwise, corporations that converted to S status before that date must retroactively apply the allocation method required by this revenue procedure.

\textsuperscript{299}Adapted from Revenue Procedure 94-61, Q&A No. 2, 1994-2 C.B. 775.
X Corp’s LRA is $300 and it will add that entire amount to the LIFO carrying value at the close of its 2005 tax year notwithstanding the fact that the last three installments of the resulting tax liability are not payable until later years.

<table>
<thead>
<tr>
<th></th>
<th>Base-Year Cost</th>
<th>LIFO Index</th>
<th>LIFO Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/01 Base Layer</td>
<td>$0</td>
<td>100%</td>
<td>$0</td>
</tr>
<tr>
<td>12/31/01 Layer</td>
<td>0</td>
<td>110%</td>
<td>0</td>
</tr>
<tr>
<td>12/31/02 Layer</td>
<td>0</td>
<td>115%</td>
<td>0</td>
</tr>
<tr>
<td>12/31/03 Layer</td>
<td>0</td>
<td>120%</td>
<td>0</td>
</tr>
<tr>
<td>12/31/04 Layer</td>
<td>0</td>
<td>130%</td>
<td>0</td>
</tr>
<tr>
<td>12/31/04 Layer (Combined)</td>
<td>$1,500</td>
<td>126.67%</td>
<td>$1,900</td>
</tr>
</tbody>
</table>

Under Revenue Procedure 1994-61, 1994-2 C.B. 775:

1. the layers are collapsed into a single December 31, 2005 layer having a base-year cost of $1,500 and a LIFO carrying value of $1,900 ($1,600 + $300);

2. neither the base-year, nor the cumulative base-year cost, nor, in the case of dollar-value LIFO-method corporations, the base-year costs (used in computing subsequent LIFO indexes under the double-extension method), nor the cumulative index (used in computing subsequent LIFO indexes under the link chain method) change; and

3. a recomputed index for the combined layer would be $126.67 ($1,900/$1,500), but this index is only relevant for the purpose of computing the LIFO-carrying value of subsequent decrements to this collapsed layer (i.e., where base-year cost of ending inventory in a subsequent tax year falls below $1,500).

300 See supra Part II.B.2. (“Dollar-Value LIFO).

301 But see Howard A. Stone, Treatment of LIFO Inventory Reserve When Converting From C to S Status, 22 Tax Adviser 646 (Oct. 1991). Mr. Stone recommended the adjustment be made by (1) preserving the existing LIFO layers, (2) restating the LIFO values of each layer using the recomputed LIFO index, and (3) that the recomputed LIFO index be used only for the purpose of valuing a subsequent decrement to one or more of the conversion-date layers.
B. LIFO Inventory Held Indirectly Through a Partnership

As previously observed, the regulations under section 1363(d) require a converting corporation that owns LIFO inventory indirectly through one or more partnerships at the time of its conversion to increase its outside basis in its lookthrough partnership interest by the amount of the lookthrough LRA. These regulations also provide for an election under which the partnership is permitted to adjust its basis in its LIFO inventory by the amount of the LRA recaptured by the converting corporation. Where the LIFO inventory is held by a lower-tier partnership, an election is also available to the higher-tier partnership that will permit the higher-tier partnership to increase its outside basis in its lookthrough partnership interest by the amount of the lookthrough LRA.

<table>
<thead>
<tr>
<th></th>
<th>Base-Year Cost</th>
<th>LIFO Index</th>
<th>LIFO Carrying Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/01 Base Layer</td>
<td>$1,000</td>
<td>126.67%</td>
<td>$1,267</td>
</tr>
<tr>
<td>12/31/01 Layer</td>
<td>200</td>
<td>126.67%</td>
<td>$253</td>
</tr>
<tr>
<td>12/31/02 Layer</td>
<td>0</td>
<td>126.67%</td>
<td>$0</td>
</tr>
<tr>
<td>12/31/03 Layer</td>
<td>100</td>
<td>126.67%</td>
<td>$127</td>
</tr>
<tr>
<td>12/31/04 Layer</td>
<td>200</td>
<td>126.67%</td>
<td>$253</td>
</tr>
<tr>
<td>Totals:</td>
<td>$1,500</td>
<td></td>
<td>$1,900</td>
</tr>
</tbody>
</table>

Mr. Stone noted that while this method and the method illustrated in the example will produce identical results (all these layers have the same index), the retention of the layer structure will facilitate the combination of this inventory with other inventories in the event that the corporation subsequently receives LIFO inventory from another entity in certain nontaxable carryover-basis transactions or transfers its inventory to another C corporation in certain nontaxable carryover-basis transactions. Id. at 646-47.

302Reg. § 1.1363-2(e)(2)(i); see supra Part IV.C. (“LIFO Inventory Held Indirectly Through a Partnership”).

303Reg. § 1.1363-2(e)(2)(ii).
partnership to adjust its basis in the interest it owns in the lower-tier partnership. The election is made by the partnership (not by the converting corporation) by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the recapture date.

1. Inside Basis Adjustments

These inside basis adjustments are treated in the same manner and have the same effect as adjustments to the basis of partnership property under section 743(b) and Regulation section 1.743-1(j). Generally stated, section 743(b) permits the

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304 Id.
305 Regulation section 1.1363-2(e)(3), last sentence, reads:

This statement shall state that the partnership is electing under this paragraph (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.

306 Since section 743(b) applies only upon the “transfer of an interest in a partnership by sale or exchange or upon the death of a partner,” the converting corporation’s recognition of its share of the partnership’s LRA would not, under section 743(b), translate into a basis adjustment in the partnership’s LIFO inventory (or in the partnership’s interest in a lower-tier LIFO-method partnership), even where the partnership had a section 754 election in effect. (Where the conversion results from the making of an S election, the “sale or exchange” required to animate section 743(b) does not occur. Where the conversion is the result of a nontaxable carryover-basis transaction, section 743(b) would not apply because the transferee corporation’s basis in the partnership interest would be the same as the converting corporation’s basis (which would have already been stepped up, at the instant before the transfer, to reflect the recognition of the LRA under Regulation section 1.1363-2(b)(2), -2(e)(2)(i)). I.R.C. § 362(b).)
purchaser of a partnership interest (or the beneficiary of a deceased partner’s interest) (the transferee) to treat the acquisition of the partnership interest in roughly the same manner as if the transferee had instead purchased (or inherited) its proportionate share of each of the partnership’s assets directly from the partnership, and had then contributed those assets to the partnership in exchange for a partnership interest. The effect of these deemed transactions is to give the transferee partner an inside basis in the partnership’s assets equal to the partner’s outside basis in the acquired partnership interest, and to thereby purge these assets of the unrealized gains or losses built into them as of the date of the transferee’s acquisition of the partnership interest.307

To insure that these basis adjustments affect only the transferee partner, the partnership retains its “common basis” in each of its assets (i.e., its inside basis determined immediately before the section 743(b) adjustment), and computes and records a transferee-specific “special basis adjustment” for

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307As a general rule that is subject to numerous exceptions, a partnership interest is an asset that is treated as separate and distinct from the assets owned directly by the partnership. This is a manifestation of the entity concept (versus the aggregate concept), and it is reflected in the general rule of section 743(a), which provides that a transfer of a partnership interest in a sale or exchange, or at a partner's death, does not generally affect the partnership’s basis in partnership property. See supra notes 220, 225.
each of these assets. Because the section 743(b) adjustment is to be made “with respect to the transferee partner only,” it normally affects only the transferee’s distributive share of the partnership’s income, deductions, etc..\textsuperscript{308} For example, when a partnership sells an asset, it will calculate its gain or loss using the partnership’s common basis in that asset. The partnership allocates this gain or loss among its partners, including the transferee partner, in the normal manner and adjusts the partners’ capital accounts accordingly. The partnership then adjusts the transferee’s distributive share of the item’s gain or loss to reflect the transferee’s special basis adjustment under section 743(b).\textsuperscript{309}

But for this inside-basis adjustment, the converted corporation would be required to recognize the lookthrough LRA again when the partnership disposes of the LIFO inventory in a taxable sale or exchange, when the converted corporation disposes of its partnership interest in a taxable sale or exchange.

\textsuperscript{308}One exception is where the partnership contributes its property to a corporation in a section 351 exchange. The corporation’s basis in the acquired assets will include the balance of any special basis adjustments made with respect to the contributed property. Reg. § 1.743-1(h)(2)(i).

\textsuperscript{309}Reg. § 1.743-1(j)(2). Similar adjustments are made in computing the purchasing partner’s distributive share of depreciation. Reg. § 1.743-1(j)(4).

These adjustments to the transferee’s distributive shares must be reflected on Schedules K and K-1 of the partnership’s return (Form 1065). They do not, however, affect the transferee’s capital account. Reg. § 1.743-1(j)(2).
exchange,\textsuperscript{310} or when the converted corporation or another partner receives a “disproportionate distribution.”\textsuperscript{311} If any of these events occur within the ten-year recognition period, some or all of the resulting ordinary income may be subject to corporate-level taxes (again) under section 1374.\textsuperscript{312} Nor is there anything in the Code or the regulations that would prevent this income from being taxable at the shareholder level (also for a second time if the E&P resulting from the earlier recognition of the lookthrough LRA under section 1363(d) has been, or will ultimately be, distributed to them as an ordinary dividend under section 1368(c)(2)).

2. Mechanics of Inside Basis Adjustments to LIFO Inventory

The regulations do not specify how the basis adjustment to the partnership’s LIFO inventory is to be made. In contrast to

\textsuperscript{310}I.R.C. § 751(a) (selling partner must recognize ordinary income (or loss) to the extent that the consideration received in exchange for all or part of its partnership interest is attributable to that partner’s share of partnership “unrealized receivables” or inventory).

\textsuperscript{311}I.R.C. § 751(b) (taxable exchange is imputed between the distributee partner and the partnership where a distribution of partnership assets alters the relative interest of any partner’s interest in the partnership’s unrealized receivables or inventory).

Where the partnership does not make the election to step-up the converted corporation’s inside basis in its share of the partnership’s LIFO inventory, the duplicate recognition of this ordinary income will, however, have the collateral effect of increasing, dollar-for-dollar, the capital loss (or reducing, dollar-for-dollar, the capital gain) built into the converted corporation’s lookthrough partnership interest. See supra note 221.

\textsuperscript{312}But see supra note 214.
LIFO inventory held directly by a converting corporation, only the converting corporation’s distributive share of the LRA built into the value of the LIFO inventory held by the partnership is recognized.

In order to implement the principles set forth in Revenue Procedure 94-61, 1994-2 C.B. 775, the partnership should, in the author’s opinion, continue to account for its LIFO inventory as if nothing had happened. It should retain its base year, the base-year costs and LIFO values of each of the LIFO layers, the dollar-value indexes, etc. It should record the lookthrough LRA recognized by the converting corporation as a separate amount. If and when the partnership experiences a decrement in the quantity of the inventory on hand as of the date the lookthrough LRA was determined, the converted corporation’s distributive share of partnership income should be reduced (as a result of increasing its share of cost of goods sold) by the portion of the LRA adjustment balance allocable to those decremented units of inventory. This allocable portion should be determined, quite simply, by multiplying the amount of the lookthrough LRA

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313 I.e., as of the end of the recapture date or as of the first day of the partnership’s taxable year that includes the recapture date, adjusted for any contributions or distributions of inventory between that date and the recapture date. See supra Part IV.C.2. (“Recapture Date for Determining the Lookthrough LRA”).

314 For partnerships using specific-goods LIFO, units means whatever units are used to record the physical quantity of the inventory (gallons, barrels, pounds, cases, etc.). For dollar-value LIFO partnerships, units are measured
recognized by the converting corporation by a fraction, the numerator of which is the number of decremented units, and the denominator of which is the number of units in the partnership’s LIFO inventory at the time the amount of the lookthrough LRA was determined.

Example 10:

Assume the same facts as in Example 9, except that the LIFO inventory was held by a calendar-year partnership in which X Corp has held a 25% interest at all times. None of the gain built into the partnership’s LIFO inventory is allocable to any partner under section 704(c).

X Corp elected S status effective as of January 1, 2006 and included its $75 share of the partnership’s LRA (25% x $300) in the income it reported on its 2005 Form 1120. The partnership made a timely election under Regulation section 1.1363-2(e)(2)(ii) to increase X Corp’s basis in its share of the partnership’s LIFO inventory.

In the author’s opinion, the partnership should maintain its LIFO inventory without any adjustment for X Corp’s recognition of the section 1363(d) inclusion. The $75 basis step-up to which X Corp is entitled should be recorded as a separate amount that will increase X Corp’s basis in its share of that inventory and will ultimately decrease its distributive share of the gross profit that the partnership will recognize upon a subsequent taxable disposition of that inventory.

If, for example, the partnership experiences a decrement of its 2005 and 2004 LIFO layers in 2008 (base-year costs of $200 and $100, respectively), X Corp’s distributive share of partnership’s gross profit from should be reduced by $15.315

in terms of base-year-dollars. See supra Part II (“LIFO Cost-flow Assumption”).

315$75 times $300/$1,500 = $15.
VII. COROLLARY EFFECTS

A. Earnings and Profits

The accumulated E&P of a C corporation does not disappear upon the corporation’s conversion to S status or upon the transfer of its assets to an S corporation in a nontaxable carryover-basis transaction. Instead, the converting corporation’s E&P resides in the S corporation (either in the converting corporation itself or in the transferee of the converting corporation’s assets) until it is distributed to its shareholders (as a dividend under section 1368(c)(2), in redemption of stock, or in complete liquidation), or until it is transferred to another corporation under section 381(c)(2) or section 312(h).

316 The E&P of the target corporation carries over to the acquiring corporation under section 381(a)(1) (liquidation of an 80% controlled subsidiary into its parent under section 332) or section 381(a)(2) (acquisition of a target corporation’s assets in certain specified types of nontaxable reorganizations). I.R.C. § 381(c)(2). The E&P of a distributing corporation in a section 368(a)(1)(D) and 355 corporate division must be allocated between the distributing corporation and the distributed corporation(s). I.R.C. § 312(h); Reg. § 1.312-10.

317 I.R.C. § 1371(c)(2), (3). Note that although an S corporation can inherit or acquire E&P from a C corporation, it cannot itself generate E&P. I.R.C. § 1371(c)(1). This was not always the case: for tax years beginning before 1983, the operations of an S corporation could, under limited circumstances, give rise to current E&P. Section 1311(a) of the Small Business Job Protection Act of 1996, Pub L. No. 104-188, 110 Stat. 1755, eliminated any such pre-1983 accumulated E&P that remained undistributed as...
Unfortunately, the converting corporation’s E&P has the potential to create significant tax liabilities for the S corporation, or its shareholders, or both. First, nonliquidating, nonredemption distributions of an S corporation’s E&P will be taxable to its shareholders as dividend income.\footnote{Under the general rule of section 301(c), a corporation’s distributions to its shareholders (in their capacity as shareholders) come first from E&P. However, section 1368(c)(1) overrides this rule to allow an S corporation that has C corporation E&P to distribute its entire “accumulated adjustments account” (AAA) balances to its shareholders tax-free (with rare exceptions), before any distribution is deemed to come from its E&P. I.R.C. § 1368(c)(1), (2). An S corporation can, however, elect to reverse this order (and pay out taxable E&P before paying out nontaxable AAA) by making an election under section 1368(e)(3). The AAA device keeps track of how much undistributed net income has been taxed to the S corporation’s shareholders under Subchapter S. I.R.C. § 1368(e)(1).} Second, if the S corporation has any E&P as of the end of any tax year and it has passive investment income in excess of 25% of its gross receipts for the year, it may be liable for a flat 35% corporate-level tax under section 1375. Finally, if the corporation has E&P and excess passive investment income for three consecutive tax years, its S election will generally terminate as of the beginning of the fourth tax year.\footnote{I.R.C. § 1362(d)(3).} of the beginning of an S corporation’s first taxable year beginning after 1996.
With important exceptions, the recognition of the LRA under section 1363(d) will have an effect on the converting corporation’s E&P that is quite similar to the effect it has on the computation of the corporation’s ACE. Like ACE, one of the adjustments required in computing a C corporation’s current E&P is the adjustment for annual increases or decreases in its LRA.\(^{320}\) This adjustment has the general effect of placing LIFO-method C corporations on a FIFO basis for E&P purposes.\(^{321}\) Consequently, as of the beginning of the tax year in which a converting corporation’s LRA is recognized under section 1363(d), most or all of the net cumulative amount of all post-1984\(^{322}\) changes in its LRA will have already been reflected in its E&P.\(^{323}\) To prevent double-counting in the recognition year, a

\(^{320}\)I.R.C. § 312(n)(4). If the corporation’s LRA is larger at the end of the current year than it was at the end of the preceding year, the difference increases E&P; if it is smaller, the difference reduces E&P. Although the LRA cannot be negative, negative LRA adjustments reduce E&P. However, except as otherwise provided in regulations yet to be issued, these negative adjustments cannot reduce the LRA below the LRA that existed as of the close of the tax year immediately preceding the corporation’s first tax year beginning after September 30, 1984. Recall that the regulations under section 56(g) do permit negative adjustments to ACE even where these adjustments exceed the cumulative net positive LRA adjustments (if any) made in computing ACE in prior years. Reg. § 1.56(g)-1(f)(3)(v), Ex. (1). See supra note 274.

\(^{321}\)Note, however, that the increases in a C corporation’s current E&P that result from increases in its LRA cannot be contemporaneously reduced by the additional corporate income taxes that will be payable in later years when the LRA is actually taken into account in computing the corporation’s taxable income.

\(^{322}\)Section 312(n)(4) was effective for tax years beginning after September 30, 1984.

\(^{323}\)Although the LRA is calculated in the same manner under section 1363(d) and under section 312(n)(4) (i.e., subtracting the LIFO value of the inventory from its FIFO value), the LIFO and FIFO inventory values used in making these respective calculations may, presumably, differ. Although the
negative adjustment is for the LRA recognized under section 1363(d) to derive the converting corporation’s E&P.

Example 11:

X Corp is a calendar-year LIFO-method C corporation that was formed in 1980. It converted to S status effective January 1, 2006. As of the close of December 31, 1984, its LIFO inventory had a LIFO basis of $4M, and a FIFO value of $9M. As of the close of December 31, 2005, its LIFO inventory had a LIFO basis of $15M, and a FIFO value of $45M. Assume that X Corp’s LIFO and FIFO values are the same for E&P purposes as they are for regular taxable income purposes, that the corporation is subject to a combined effective federal and state income tax rate of 40%, and that it has no AMT credit carryforwards.

Under section 1363(d), X Corp’s conversion to S status will trigger (1) the immediate recognition of its $30M\(^{324}\) section 1363(d) inclusion, and (2) an incremental tax liability of $12M,\(^{325}\) payable in four equal annual installments beginning on March 15, 2006, and ending on March 15, 2009. The recognition of X Corp’s section 1363(d) inclusion will initially cause its current E&P to increase by $30M. However, the recognition of this income will also cause X Corp’s LRA to decrease by $30M to $0. Since changes in the LRA cannot reduce E&P below the LRA that existed as of December 31, 1984,\(^ {326}\) the reduction in current E&P will be limited to $25M.\(^ {327}\)

Before taking into account the effect on E&P of the income taxes that X Corp must pay on the section

\(^{324}\)$45M - $15M = $30M.

\(^{325}\)$12M times 40% = $4M.

\(^{326}\)See supra note 319.

\(^{327}\)$30M minus ($9M minus $4M) = $25M.
1363(d) inclusion (discussed below), its current E&P will increase by a net amount of $5M.\textsuperscript{328}

B. \textit{Adjustments for the Incremental Tax Imposed on the Section 1363(d) Inclusion}

The Code variously requires that the E&P of a C corporation, the “accumulated adjustment account” (AAA) of an S corporation,\textsuperscript{329} and the basis the shareholders of an S corporation have in their stock\textsuperscript{330} be reduced by nondeductible, noncapital expenses.\textsuperscript{331} Federal income taxes, and more specifically, the corporate-level income taxes imposed on the section 1363(d) inclusion, are nondeductible, noncapital expenses. Since the converting corporation will be a C corporation at the time the tax resulting from the recapture of the LRA become “fixed and determinable,”\textsuperscript{332} but it (or, following a nontaxable carryover-basis transaction, its successor) will be

\textsuperscript{328}$30M \text{ minus } $25M = $5M.


\textsuperscript{330}I.R.C. § 1367(a)(2)(D); Reg. § 1.1367-1(c)(2).

\textsuperscript{331}Examples of expenses falling into this category include illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162.

\textsuperscript{332}I.e., as of the last day of the converting corporation’s last C year, all events will have occurred which determine the fact of its liability under
questions arise as to whether the corporation’s E&P, AAA, or its shareholders’ stock basis are to be adjusted for the tax, and, if so, when the adjustments are to be made (i.e., immediately on the recapture date or as the installments are actually paid).

The Code expressly provides that in computing an S corporation’s AAA, no reduction is to be made for federal taxes “attributable to” any tax year in which the corporation was a C corporation. Although neither the statute nor the regulations define the phrase “attributable to,” the incremental tax imposed on the converting corporation’s LRA clearly falls within its scope.

The effect of the incremental tax on the converting corporation’s E&P and on the stock basis of its (or its successor’s) shareholders is not, however, predicated upon whether or not this tax is “attributable to” a C corporation tax year of the converting corporation. The touchstone for making these determinations is, instead, whether the incremental tax is

\[ \text{section 1363(d) and the amount of that liability will have become determinable with reasonable accuracy. See I.R.C. § 461(h)(4).} \]

This assumes, of course, that the converting corporation’s S election (or the S election of its successor corporation) does not terminate prior to the payment of the final installment.

\[ \text{I.R.C. § 1368(e)(1)(A); Reg. § 1.1368-2(a)(3)(C)(1). Note, by way of contrast, that the corporate-level taxes paid under section 1374 on the S corporation’s net recognized built-in gains are treated as losses incurred by the S corporation and therefore reduce the corporation’s AAA (and the stock basis of its shareholders). I.R.C. § 1366(f)(2). See supra note 17.} \]
deemed to have been “incurred” in the converting corporation’s last C year, or, conversely, in a subsequent S year. Simply put, any portion of the incremental tax that is incurred in a C year will reduce the converting corporation’s E&P and will have no effect on the stock basis of its (or its successor’s) stockholders. Conversely, any portion of the incremental tax that is incurred in the converted corporation’s S years will have no effect on its E&P and will reduce its shareholders’ stock basis.

1. Background: The Economic Performance Test

An accrual-method corporation’s liability for federal, state, and local income taxes is “incurred” (and therefore recognized) for any and all federal income tax purposes only when the “all-events” test of section 461(h)(4) is met. The all-events test is met no earlier than when the “economic

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335 Section 461(h)(1) reads:
In general. For purposes of this title, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. (emphasis added).

336 Section 461(h)(4) reads:
All events test. For purposes of this subsection, the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy. See also Reg. §§ 1.446-1(c)(1)(ii)(A), 1.451-1(a).
performance” occurs.\textsuperscript{337} For liabilities in the form of taxes, economic performance does not generally occur until the tax in question is actually paid.\textsuperscript{338}

An exception to the payment requirement is available to accrual method taxpayers that adopt the “recurring item exception” of section 461(h)(3).\textsuperscript{339} Under this exception, taxes will be treated as having been incurred during a particular taxable year \textit{if and only if} (1) the all-events test is satisfied before the close of that taxable year, (2) payment of the tax is made within a “reasonable period” (but no later than 8 ½ months) after the close of such taxable year, and (3) the taxes are recurring in nature and the taxpayer consistently treats taxes of the kind in question as incurred in the taxable year in which the all-events test is satisfied.\textsuperscript{340}

\textsuperscript{337}I.R.C. § 461(h) (generally applies to amounts incurred on or after July 18, 1984); see also Reg. § 1.461-1(a)(2)(i).

\textsuperscript{338}Reg. § 1.461-4(g)(6). An exception to this requirement is available under section 461(c), which allows an accrual method taxpayer to elect to accrue certain real property taxes ratably over the period to which they relate, regardless of when those taxes are actually paid. In T.A.M. 1999-04-036 (Sept. 30, 1998), the taxing authority allowed the taxpayer to pay a sales tax liability resulting from an asset acquisition over a period of years. The I.R.S. held that payment, and therefore economic performance, occurred as each payment was made and not when the asset was acquired.

\textsuperscript{339}An accrual-method taxpayer may generally adopt the recurring item exception as method of accounting for one or more types of recurring liabilities that it incurs during a taxable year. Reg. § 1.461-5(a). See Regulation section 1.461-5(d) for the time and manner of adopting the recurring item exception.

\textsuperscript{340}I.R.C. § 461(h)(3); Reg. § 1.461-5(b). For most liabilities, the recurring item exception also requires that either (1) the amount of the liability in question is not “material,” or that (2) the accrual of that liability in the taxable year in which the all-events test is met results in a better “matching” with the income to which it relates than would result
With respect to the incremental tax on the section 1363(d) inclusion, the converting corporation will have been a C corporation at the time the all-events test of section 461(h)(4) was satisfied, but it (or its successor) will be an S corporation at the time these taxes are actually paid. A converting corporation that has adopted the recurring item exception, and that pays the incremental tax in installments as they become due, should be permitted to treat the tax paid with the first installment as having been incurred in the recognition year — while it was still a C corporation. The taxes paid with the last three annual installments, however, will be treated as having been incurred in years during which the converted corporation was an S corporation.

Since the converting corporation’s liability for the incremental tax on the section 1363(d) inclusion becomes fixed and determinable in the recognition year, and since the statute expressly authorizes the prepayment of this tax, it seems clear that, for a converting corporation that has adopted the

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341 This assumes, of course, that the converting corporation does not prepay the entire incremental tax in the recognition year and that its S election (or the S election of its successor corporation) does not terminate prior to the payment of the final installment.

342 See, e.g., Reg. § 1.461-4(g)(8), Ex. (8).
recurring item exception, prepayment of all or part of any or all of the last three installments within a reasonable period (or 8 1/2 months, whichever is shorter) following the close of the recognition year, will result in those taxes being incurred in the recognition year.

2. Earnings and Profits

The E&P of an accrual method C corporation is reduced by accrued federal income taxes. Section 1371(c), however, provides that no adjustments are to be made to the E&P of an S corporation except (1) where those earnings are distributed out to the shareholders as dividends under section 1368(c)(2), (2) where the corporation redeems its stock or liquidates, or (3) where the corporation acquires, disposes, or allocates E&P as a result of the application of a subchapter C provision to a reorganization or division. Section 1371(d)(3) provides another exception that permits an S corporation to reduce its

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343 I.R.C. § 1363(d)(2)(B) ("... the 3 succeeding installments shall be paid on or before the due date ... for the corporation’s return for the 3 succeeding taxable years." (emphasis added)).

344 Consequently, for example, neither the recognition of built-in gains and losses under section 1374, nor the payment of corporate-level taxes on net recognized built-in gains will have any effect on an S corporation’s E&P. Nor will the recognition of “excess net passive income” or the payment of corporate-level taxes thereon under section 1375 have any affect on an S corporation’s E&P.

Section 1371(c) was enacted as part of the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1689.
E&P for any additional taxes for which it is liable under the investment credit recapture provisions of sections 49(b) or 50(a).

Read literally and together, sections 1371(c) and 461(h) preclude a reduction in the converting corporation’s E&P for any amount of the incremental tax not deemed to have been incurred while it was still a C corporation — notwithstanding the fact that such tax is attributable to a C year of that corporation. Consequently, a converting corporation that has not adopted the recurring item exception will not reduce its E&P for any amount of the incremental tax paid after the close of the recognition year. A converting corporation that has adopted the recurring item exception, and that pays the incremental tax in installments as they become due, will reduce its E&P by the amount of the first installment, but no reduction will be permitted for any of the three remaining installments. However, a converting corporation that has adopted the recurring item exception should be permitted to reduce its E&P by any prepayments on the final three installments that are made within a reasonable period (or 8 1/2 months, whichever is shorter) following the close of the recognition year.

In the author’s opinion, the failure of the Code and regulations to permit the converting corporation to reduce its
E&P by the full amount of the incremental tax in the recognition
year is clearly at odds with the whole concept of corporate E&P
- i.e., that the before-tax corporate-level earnings and profits
of a C corporation should be reduced by the corporate-level
taxes attributable to them. In a closely analogous situation,
Congress belatedly “clarified” the treatment of federal income
taxes paid by an S corporation upon the recapture of investment
tax credits previously claimed by the corporation in a prior C
year. As noted above, section 1371(d)(3) permits an S
corporation to reduce its E&P by the full amount of such
taxes.345

This failure to reduce E&P by the full amount of the
incremental tax also conflicts with the legislative purpose that
triggered the enactment of section 1363(d): “[t]o eliminate
[the] potential disparity in treatment” between FIFO-method and
LIFO-method converting corporations.346 As of the date of its
conversion to S status, a FIFO-method C corporation would have
already reduced its E&P by the income taxes attributable to its
inventory profits.

345Staff of Joint Comm. on Tax’n, 98th Cong., General Explanation of the Revenue
clarifies that an S corporation’s accumulated earnings and profits will be
reduced by the amount of investment credit recapture tax . . . imposed on the
corporation with respect to these credits, since the earnings and profits
were not previously reduced by the amount of tax savings attributable to the
credit.” (emphasis added)).

3. Stock Basis

Failure to adjust the converting corporation’s E&P by the incremental tax is an inequity that is exacerbated by section 1367(a)(2)(D), which requires, without qualification, that the shareholders of an accrual-method S corporation reduce their stock bases by their pro rata share of the nondeductible, noncapitalizable expenses incurred during the year.\textsuperscript{347} It seems clear that this requirement extends to any amount of the incremental tax that is deemed, under the rules discussed above, to have been incurred during an S year of the converted corporation, notwithstanding the fact that such tax is, in its entirety, attributable to a C year of the converting corporation.\textsuperscript{348}

\textsuperscript{347}Reg. § 1.1367-1(c)(2), -1(d)(2).

\textsuperscript{348}Although Regulation section 1.1367-1(c)(2) does not include the incremental tax on the section 1363(d) inclusion in its listing of the types of nondeductible, noncapitalizable expenses that fall into this category, that regulation expressly states that the listing is illustrative, not exclusive.

Section 1368 states that AAA is computed by making adjustments that are “similar to the adjustments under section 1367,” but that “no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.” I.R.C. § 1368(e)(1)(A). This language seems to confirm that federal income taxes attributable to taxable years in which the corporation was a C corporation are taken into account in making basis adjustments under section 1367 when they are incurred in an S year.

Note that the income taxes payable by a converted corporation under section 1374 also reduce stock basis. I.R.C. §§ 1366(f)(2), 1367(a)(2)(B), (C). However, unlike section 1363(d), stock basis is increased by the net recognized built-in gain on which the tax is imposed.
4. Comment on the Final Regulations

At the December 8, 2004 hearing on the proposed regulations, the author raised these issues and observed that the literal application of the current provisions creates the potential for substantial distortions in the amount, timing, and character of the income ultimately recognized by the shareholders of the converted corporation. For the reasons stated above, the section 1363(d) regulations should, in the author’s opinion, have been revised to permit the accrual of the incremental tax on the recapture date — i.e., at the time the liability for that tax becomes fixed and determinable, without regard to when economic performance ultimately occurs. This approach is consistent with the concept of E&P,\textsuperscript{349} with the legislative purpose that prompted the enactment of section 1363(d), with the treatment of corporate-level recapture taxes under section 1371(d)(3), and with the regulations under section 1374 (which apply the all-events test \textit{without regard to the economic performance requirement} in distinguishing deductions that were built-in as of the last day of the converting corporation’s prior recognition of net increases in its LRA under sections 312(n)(4) and 1363(d) would be reduced by the deferred corporate-level taxes that were triggered in the recognition year under section 1363(d).

\textsuperscript{349}I.e., the cumulative net before-tax corporate-level E&P resulting from the converting corporation’s prior recognition of net increases in its LRA under sections 312(n)(4) and 1363(d) would be reduced by the deferred corporate-level taxes that were triggered in the recognition year under section 1363(d).
corporations last tax year as a C corporation, and those that accrued subsequent to the start of the ten-year recognition period.\textsuperscript{350}

This recommendation was, unfortunately, rejected by the Treasury Department on the grounds that “[t]he issues raised by the payment by an S corporation of taxes attributable to a taxable year in which the corporation was a C corporation are not unique to a payment of the LIFO recapture tax and are beyond the scope of these regulations.”\textsuperscript{351}

In fact, the section 1363(d) incremental tax is unique and, in the author’s opinion, this uniqueness warrants the special treatment described above.

\textsuperscript{350}Regulation section 1.1374-4(b)(2) reads, in part:

\begin{quote}
Deduction items. Except as otherwise provided in this section, any item of deduction properly taken into account during the \[ten-year\] recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the \[ten-year\] recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation). In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and section 1.461-4(g) (relating to liabilities for \ldots taxes \ldots) do not apply. (emphasis added).
\end{quote}

Note also that the corporate-level tax imposed under section 1374 is treated as a loss sustained by the S corporation for the taxable year in which the built-in income or gain is recognized and the tax is imposed, regardless of the year in which the tax is actually paid. See I.R.C. § 1366(f)(2); Reg. § 1.1366-4(b).

\textsuperscript{351}Preamble, T.D. 9210, 2005-33 I.R.B. 290.
VIII. CONCLUSION

Throughout this Article, the author has identified and critically analyzed many, hopefully most, of the technical issues that can and do arise from the application of section 1363(d). As to the resolution of many of these issues, the statute is clear; as to others, the regulations and administrative pronouncements provide guidance that is consistent, or at least arguably consistent, with the statute and the legislative purposes that inspired its enactment. In many instances, however, the formal guidance that has been provided is incomplete, ambiguous, inconsistent, or subject to credible challenge by affected taxpayers. Several other issues, some of which result from the interaction between section 1363(d) and other statutory provisions, have never been formally addressed.

In Parts III through VII of this Article, the author has attempted to provide constructive insight that he hopes will prove useful to policymakers and taxpayers in resolving the uncertainties, inconsistencies, inequities, and ambiguities that presently plague section 1363(d) and that breed anxiety for corporations and shareholders contemplating an election or a transaction that would trigger its application. In the end, however, the author believes that section 1363(d) is premised on
faulty reasoning, that it unduly compromises the pro-small-business policy that originally inspired and presently sustains Subchapter S, and that, for these and other reasons, it should be repealed forthwith.

A. Arguments Favoring Repeal of Section 1363(d)

1. Abrogation of LIFO

As explained and illustrated in Part II, a taxpayer’s replacement cost of inventory changes over time. Assume that a taxpayer had 100 units in its beginning inventory that it had purchased or manufactured at a cost of $100/unit. During the current year, it purchased or manufactured an additional 100 units of the same inventory for $120/unit, and it sold 100 of the 200 units available for sale for $150/unit. Under FIFO, the $20/unit “holding gain” would be included in the taxpayer’s $50/unit gross profit and taxed in the current year. Under LIFO, the taxable gross profit would be only $30/unit, and the $20/unit holding gain would be deferred to a future tax year. The deferral of the holding (or inflationary) gains built into the value of a taxpayer’s LIFO inventory (i.e., its LIFO reserve) is the defining characteristic of the LIFO method of
accounting for inventories, and its adoption and use in determining taxable income has been expressly and continuously authorized by Congress throughout the past 65 years.352

Yet section 1363(d) was enacted for the express purpose of eliminating this disparity between LIFO- and FIFO-method taxpayers and insuring that a LIFO-method C corporation’s conversion to S status could not result in a permanent avoidance of corporate-level taxes on the LIFO reserves that accumulated as of the last day of its last year as a C corporation.353 The method chosen to achieve these objectives was to force LIFO-method converting corporations to recognize, immediately and in a single tax year, unrealized income that had accumulated over several years, perhaps decades, and which, but for section 1363(d), might otherwise have been deferred for many years or decades into the future.

The simple realities are these: (1) section 472 expressly authorizes the FIFO-LIFO disparity to which Congress took such great exception when it crafted the immediate recognition rule of section 1363(d), and (2) the potential for permanent tax avoidance could have been efficiently and effectively eliminated by far less draconian means, and without compromising or

352 See supra note 38. However, as previously observed, the LIFO method cannot be used in computing E&P (since 1984) or ACE (since 1990). I.R.C. §§ 312(n)(4), 56(g)(4)(D)(iii).

353 See supra note 21.
subverting the policy considerations on which section 472 and, to the extent section 1363(d) operates to deter the elections and transactions that trigger its application, Subchapter S are respectively grounded. At a minimum, recognition of the converting corporation’s date-of-conversion LRA could have been subjected to section 1374 for the duration of the 10-year recognition period, with any remaining balance recaptured at the end of that period, rather than at the beginning. An even more coherent and intrinsically sound approach would have been to simply extend the normal 10-year recognition period of section 1374 to 15 or 20 years, or, perhaps, indefinitely.

2. Realization, Wherewithal-to-pay, and Bunching of Income

Historically, the “realization” principle has been the foundational timing rule for the recognition of gains and losses under the federal income tax system.

The rule is as old as the income tax itself: “From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event . . . .” Helvering v. Horst, 311 U.S. 112, 115 (1940).

tax consequences of a gain or loss in property value until the taxpayer ‘realizes’ the gain or loss.” Although Congress has carved out several important exceptions, this principle still carries most of its original force as a condition precedent to the taxable recognition of income or gain from investments in property. The realization principle has been justified, in

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355 Cottage Savs. Assoc. v. Commissioner, 499 U.S. 554, 559 (1991). The realization requirement is implicit in section 1001(a), which defines gain or loss for income tax purposes as gains or losses arising "the sale or other disposition of" property. This definition conditions taxability upon the conversion of the taxpayer's property into cash or other property and it thereby excludes unrealized gains and losses from tax recognition. I.R.C. § 1001(a). See also I.R.C. § 1001(b) (designating the gross purchase price received by the seller of property as the "amount realized"); I.R.C. § 61(a) (“[G]ross income means all income from whatever source derived, including . . . [g]ross income derived from business [and] [g]ains derived from dealings in property . . . .”) (emphasis added). The Sixteenth Amendment to the U.S. Constitution also includes a reference to realization: “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived . . . .” U.S. CONST. amend. XVI (emphasis added)).

One scholar, however, has noted:


356 For example, several special recognition rules applicable to financial instruments. See, e.g., I.R.C. § 1092 (deferring a loss realized on one leg of a straddle until the gain on the other leg is recognized); I.R.C. § 1256 (requiring that a taxpayer mark to market annually any "section 1256 contract," including futures contracts and certain exchange-traded options); I.R.C. § 475 (generally requiring securities dealers to mark to market securities (other than those that are held for investment and clearly identified as such)); Reg. § 1.446-4 (requiring taxpayers to match the timing of items on a "hedging transaction" with the timing of items on the underlying hedged position).

357 The relative merits of the current realization-based income tax system vis-à-vis those of an accretion-based system have been, and continue to be the subject of considerable debate. See, e.g., Henry Ordower, Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to
part, by the practical problems that would otherwise result where the event, or nonevent, that triggered the recognition of unrealized gains did not itself produce the cash wherewithal required to pay the taxes on that gain.  

Section 1363(d) violates the realization principle, and, in so doing, it is inconsistent with the treatment of C-to-S conversions as nonevents, and with the approach taken by its companion provision, section 1374, to effect the repeal of the

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358 See, e.g., U.S. Dep’t of the Treasury, Blueprints for Basic Tax Reform, at 73 (1977) (concluding that unrealized appreciation should not be taxed primarily because of the administrative burden, difficulty, and cost of determining asset values, and because of the hardship of obtaining funds to pay the taxes on accrued but unrealized gains); see also Fred B. Brown, “Complete” Accrual Taxation, 33 SAN DIEGO L. REV. 1559, 1560 (1996) ("[A]ccrual taxation presents serious problems of its own — the difficulty of valuing assets and possible taxpayer illiquidity."); Thomas L. Evans, The Evolution of Federal Income Tax Accounting—A Growing Trend Towards Mark-to-Market?, 67 TAXES 824, 825 (1989) ("Basing taxable income on economic gain not yet reduced to liquid wealth could, moreover, impose significant hardships on certain taxpayers who would be unable to pay the tax owed because of the illiquid nature of the economic gain."); Carl S. Shoup, The White Paper: Accrual Accounting for Capital Gains and Losses, 18 CAN. TAX J. 96, 99 (1970) (advantages of mark-to-market system “will of course not be obtained without cost, notably the difficulties of valuation and the problem of cash payments of tax on an accrued gain”).

359 But see supra note 1.
General Utilities doctrine.\textsuperscript{360} It bears repeating: the income recognized and taxed when a C-to-S conversion triggers the application of section 1363(d) is unrealized income that accumulated over the years, perhaps decades, that the inventory held by the converting corporation was accounted for under LIFO.\textsuperscript{361} Since the income recognized under section 1363(d) does not derive from actual sales or exchanges of the corporation’s LIFO inventory, the cash burden of the resulting taxes can create a potentially severe wherewithal-to-pay problem.\textsuperscript{362}

3. Economic Efficiency and Neutrality

Section 1363(d) distorts economic decision-making and undermines economic efficiency. For many, perhaps most, LIFO-method C corporations, the amount of the incremental tax, in both absolute and relative terms, will be substantial, and

\textsuperscript{360}See supra note 15. Section 1374 taxes built-in gains only if and when the underlying assets are subsequently disposed of in a taxable sale or exchange within the ten-year recognition period.

\textsuperscript{361}Additionally, the bunching of several years worth of accrued LRA into a single tax year will typically result in the imposition of a marginal tax rate that is higher than the marginal rates that would have applied had that income been spread out over the years during which it economically accrued.


This liquidity problem is mitigated somewhat by the fact that the resulting incremental tax is payable over three years. Note, however, that the installment payment rule does not in any way ameliorate the bunching of many years worth of appreciation into a single tax year.
therefore, a significant, possibly controlling factor in deciding whether to make an S (or QSub) election, or whether to participate in a transaction (for example, the disposition of assets to an S corporation in an otherwise nontaxable reorganization) that will trigger the application of section 1363(d). This is true for two reasons. First, as observed under the previous subheading, the imposition of the incremental tax can create a liquidity problem that might prove insurmountable or that threatens the financial health and viability of the corporation.

Second, where it applies, section 1363(d) requires LIFO-method C corporations to accelerate the recognition of income that would have otherwise been deferred for many years, perhaps many decades, into the future. In most cases, the present value of the installment payments due under section 1363(d) will far exceed the estimated present value of the taxes that would otherwise be payable in distant future years when the corporation’s inventory is sold (and the current LIFO reserve is eventually recognized and taxed). When this net tax cost exceeds the present value of tax savings that the corporation expects to derive from its conversion to S status, section 1363(d) can deter C corporations with substantial LIFO reserves from
availing themselves of the benefits of Subchapter S. Section 1363(d) can likewise have the effect of quelling otherwise deserving corporate acquisitions by S corporations where the target corporation is a LIFO-method C corporation with substantial LIFO reserves.

363This observation, together with calls for the repeal of section 1363(d), have been made repeatedly by informed commentators. One commentator noted:

Imposing a LIFO recapture rule on corporations making S elections will present a substantial cost to many businesses that have been using the LIFO method for a period of years, especially if costs have been rising over time. Thus, Congress' first attempt to exact an immediate toll charge for converting from C to S status in new Section 1363(d) may force many taxpayers to forgo making the election despite the fact that the tax attributable to the adjustment may be paid over four years.


Often times the most significant hurdle faced by a corporation desiring to elect S corporation status is the LIFO recapture tax under IRC section 1363(d). In many cases, this tax makes it cost-prohibitive for a corporation to elect S status. . . . We recommend that IRC section 1363(d) be repealed and that IRC section 1374 be amended to provide that the ten year recognition period not apply with respect to any LIFO inventory held by a corporation on its date of conversion to S status.


William B. Kelliher, chairman of the S Corporation Study Group, concluded that section 1363(d) "is a significant deterrent to making an S election for corporations using the LIFO inventory method." He favored repealing the provision and recognizing built-in gain associated with a LIFO inventory "only if a 'C corporation layer' of LIFO inventory is invaded during the 10-year recognition period." William B. Kelliher, S Corporation Study Group Suggests Revisions to Subchapter S, 47 TAX NOTES (TA) 1055, 1055-56 (May 28, 1990). See also, Comments on Statutory Disincentives to S Corporation Election, 93 TAX NOTES TODAY 104-13 (May 16, 1990) (LEXIS, LFEDTAX lib., TNT file, elec. Cit 90 TNT 104-13); John Yanoshak et al., Rethinking the S Election: Disadvantages of S Status May Outweigh Tax Benefits, 26 TAX ADVISOR 42 (1995); Troy S. Watkinson, LIFO Recapture on Conversion from C
Section 1363(d) also undermines equity, neutrality, and economic efficiency by creating a strong bias against LIFO-method C corporations. Notwithstanding, the shared purpose that prompted their enactment, i.e., the repeal of the General Utilities doctrine, the approaches respectively taken by section 1374 and section 1363(d) to achieve this purpose are at opposite ends of the spectrum. Section 1374 taxes built-in gains (1) only if and when the underlying assets are subsequently disposed of in a taxable sale or exchange within the ten-year recognition period, and it (2) limits the amount of the net recognized built-in gains that will be subject to corporate-level taxes to the corporation’s net unrealized built-in gain. Section 1363(d), on the other hand, mandates (1) immediate recognition of the bulk of the gross unrealized appreciation built-into the value LIFO inventory, and (2) ignores any net unrealized built-in loss the converting corporation might have in its other assets.

Example 12:

X Corp is a calendar-year LIFO-method C corporation that converted to S status effective January 1, 2006. As of the close of December 31, 2005, its LIFO inventory had a LIFO basis of $15M, a FIFO

value of $45M, and a fair market value of $50M. Its only other assets are operating assets that had an adjusted basis of $100M and a fair market value of $75M on that date. Assume that X Corp is subject to a combined effective federal and state income tax rate of 40% and that it had not AMT credit carryforwards.

Under section 1363(d), X Corp’s conversion to S status will trigger the immediate recognition of $30M\textsuperscript{366} of taxable ordinary income, all of which will be subject to corporate-level taxes (totaling $12M) that must be paid in full over the three year period (March 15, 2006 through March 15, 2009) following the corporation’s conversion. This is true notwithstanding the fact that the inventory was not disposed of in a sale or taxable exchange, and notwithstanding the fact that X Corp’s overall net unrealized built-in gain is only $10M.\textsuperscript{367}

But if the LIFO inventory held by X Corp in this Example had instead been any other kind of operating or investment asset, none of the $35M\textsuperscript{368} built-in gain would have been taxable in the year of X Corp’s conversion to S status. If X Corp subsequently sold that asset for $50M in the 10th year following its S election, only $10M of the corporation’s $35M gain would be subject to corporate-level taxes (totaling $4M) under section 1374, and those taxes would be payable in the year of sale, 2015.

Any tax inevitably discourages the type of activity that is taxed. An ideal tax system interferes with private decisions as little as possible – it does not unnecessarily distort choices or create artificial distinctions between similarly-situated taxpayers.\textsuperscript{369} Subchapter S was enacted to address these very

\textsuperscript{366}$45M - $15M = $30M.
\textsuperscript{367}$50M + $75M - $15M - $100M = $10M.
\textsuperscript{368}$50M - $15M = $35M.
\textsuperscript{369}See David W. LaRue, A Case for Neutrality In the Design and Implementation of the Merger and Acquisition Statutes: The Post-Acquisition
concerns: to further the overall federal policy of promoting the formation and growth of small businesses by allowing small businesses to “operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties.” Section 1363(d) impairs the achievement of these goals and, as noted above, it does so needlessly.

4. Complexity and Uncertainty

As evidenced by the discussions and analyses presented in the earlier sections of this Article, the rules required to eliminate uncertainty and to definitively resolve the multitude of issues that emanate from section 1363(d) are intricate. Most, or perhaps all, of this complexity, and much of the prevailing uncertainty, is, in the author’s opinion, gratuitous: it exists only because gain built-into a converting corporation’s LIFO inventory is treated differently from other built-in gains. Repealing section 1363(d) and subjecting the gain built into a

converting corporation’s LIFO inventory to section 1374 would eliminate redundant complexity and considerably reduce the uncertainty that presently exists as to the proper resolution of many of the issues arising under section 1363(d).\footnote{Although section 1374 and the maze of regulations, administrative and judicial rulings can be daunting, they are considerably more comprehensive in identifying and addressing the various issues. AICPA Releases Tax Simplification Recommendations, 90 Tax Notes Today 91-7, 58-59 (Apr. 30, 1990) (LEXIS, FEDTAX lib., TNT file, elec. cit. 90 TNT 91-7):}

B. Application of Section 1374 to LIFO Inventories

In the author’s opinion, section 1363(d) should be repealed and the post-conversion liquidations of a corporation’s conversion-date LIFO reserves should be taxed under section

\footnote{Repeal of the LIFO recapture rule would eliminate a substantial impediment to the making of the S election by affected corporations and would promote simplicity by removing a complex provision in the code requiring complex calculations. The LIFO recapture rule is an impediment to the making of the S election in that it forces affected corporations to pay tax on income for which an economic benefit has not yet been realized. Furthermore, it unfairly targets specific industries for which the accounting for inventories on the LIFO method is the common practice. Especially affected adversely are wholesalers, distributors and retailers, many of which are small family owned businesses. The rule requires calculations of the inventory amount using both the LIFO and FIFO methods and results in a basis adjustment to the inventory for tax purposes that may not be recognized for financial reporting purposes under generally accepted accounting principles (GAAP). This results in complex recordkeeping requirements to account for these differences between tax and financial reporting. Furthermore, since a corporation that pays the LIFO recapture tax will be an S corporation at the time of payment, complex rules must be prescribed to account for the effect of the payment of the tax on the accumulated adjustments account and the stock basis for the shareholders. This complexity would be eliminated by the repeal of [section 1363(d)].}
1374. Section 1374 should be modified to extend, perhaps to 15 or 20 years, perhaps indefinitely, the recognition period for built-in LIFO reserves.\textsuperscript{372} This approach would eliminate most of the distortion, inequity, inefficiency, redundant complexity, and uncertainty created under the current statute, while simultaneously, and effectively, addressing the concerns that inspired its enactment.

\textsuperscript{372}This is not as impractical as it may seem at first glance. LIFO-method taxpayers must keep fairly detailed records going back all the way to the year the LIFO method was adopted. Reg. § 1.472-2(h). The Service takes the position that failure to maintain adequate books and records can be grounds for termination of the LIFO election. Rev. Proc. 79-23, § 3.01(d), 1979-1 C.B. 564. See \textsc{Stephen F. Gertzman, Federal Tax Accounting}. 7-28,-29 (2d ed., Warren, Gorham and Lamont (1993):

The LIFO method is based on the concept that the last goods acquired are the first goods sold. Accordingly, the earliest goods acquired are treated as the goods remaining in inventory. As a consequence, LIFO computations are often based on data accumulated at the beginning of the year of the adoption of LIFO. It is essential that the taxpayer retain all books, records, worksheets and other material supporting its LIFO computations throughout the period of its adoption and use of LIFO.

It is worth noting that the idea of an unlimited recognition period is not without precedent. Amounts includible in income under section 593(e) (relating to the recapture of pre-1988 bad debt reserves on distributions from thrift institutions) are subject to section 1374 regardless of how long after the corporation’s conversion that such income is recognized. I.R.C. § 1374(d)(7) (as amended by Pub. L. No. 105-34, § 1601(f)(5) (1997)).

At a minimum, recognition of the converting corporation’s date-of-conversion LRA could have been subjected to section 1374 for the duration of the ten-year recognition period, with any remaining balance recaptured at the end of that period, rather than at the beginning.