Built-in Gains Regs. Hearings Reap AICPA Comments

by Robert W. Wood • San Francisco

Even though hearings have been held on the proposed built-in gains tax regulations under Section 1374, it does not necessarily follow that the IRS will be revising the regulations to take into account the comments made at the hearing. (For prior coverage of the proposed regulations, see "Built-In Gains Prop. Regs. Offer Relief," 1 *M&A Tax Rep't* 6 (January 1993), p. 1.) However, a couple of points made by the AICPA deserve mention.

Unfair Accruals

The AICPA has criticized the accrual concept that is generally adopted under the proposed rules for purposes of determining which taxpayer gets a built-in deduction on a conversion to S status. Built-in deductions, of course, are the key to many conversions from C to S status that may precede a sale of assets or the entire business. For example, it had widely been assumed that there would be no problem with accruing compensation (such as bonuses to shareholders) before the conversion to S status, and claiming these amounts as built-in deductions.

Unfortunately, under the proposed regulations, anything that would prevent the accrual of such items for normal tax purposes—such as the related-party rules of Section 267—would prevent the item from qualifying as a built-in deduction. This conflicts with the legislative history of Section 1374. It also conflicts with what many taxpayers have done since the provision was added in 1986—accruing compensation. The good news is that the regulations on this point are only proposed, and effective only after final regulations are published.

Partnership Look-Through

The general look-through rule for partnership interests held by corporations will be a real nightmare to administer. *The de minimis* rule for partnership interests, which provides limited relief, does not specify *when* the value of the interest is to be measured. While the proposed regulations say that the value of the partnership interest cannot exceed $100,000, they do not indicate when the determination is to be made.

Inventory Valuation

In addition, the valuation method for inventory under the proposed rules is not entirely clear. The IRS had rejected the replacement cost approach suggested by the AICPA. Instead, the proposed regulations state that inventory of the converting entity is to be valued based on an assumed sale between a willing buyer and a willing seller of all of the corporation's assets.

This may sound like a bulk-sale approach, but the AICPA has criticized the rule as vague. Many Revenue Agents are reportedly taking the position in the field that the proper valuation is *retail* value! The bottom line is that many corporations converting from C to S status that maintain inventories will be hit with immediate exposure to the built-in gains tax. ■