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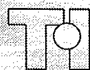

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Built-In Gains Prop. Regs. Offer Relief

by Robert W. Wood • Bancroft & McAlister

With the current talk of likely increased individual tax rates, prompting generally shortsighted discussions of "to S or not to S" under the new administration, it should come as welcome relief that the Service's long-awaited foray into the field of built-in gains tax regulations offers some helpful interpretations. Since the built-in gains tax (Section 1374) was enacted in 1986, and fully phased-in at the end of 1988, it has stood as the bulwark against which corporate turncoats from C to S status are

Continued on Page 3

ALSO IN THIS ISSUE:

- New Section 382 Prop. Regs. Address Segregation and Convertible Stock 4
- Prop. Regs. Withdrawn on Information Returns for Acquisitions 7
- One More Word: Section 355 and Business Purpose 8

BUILT-IN GAINS Continued From Page 1

be tested. But, until now, many aspects of the built-in gains tax were unclear.

Accrual Method Concepts

The built-in gains tax operates with respect to gains triggered by a sale or other disposition of assets that appreciated during a corporation's C years, if such sale occurs within the first ten years of S status (the "recognition period"). However, the tax is more sophisticated than that. Beyond sales or exchanges of assets, Section 1374(d)(5) provides that any item of income or deduction properly taken into account during the recognition period is recognized built-in gain or loss if it is attributable to periods before the recognition period.

To implement this rule, the proposed regulations use accrual accounting concepts. Thus, an S corporation's items of income or deduction generally are treated as recognized built-in gains or losses if the item would have been taken into account before the recognition period by a taxpayer using the accrual method. The accrual method is used because valuing items of income and deduction on the first day of the recognition period would be burdensome both for the taxpayer and the Service.

The proposed regulations adopt special rules for determining recognized built-in gains and losses in the case of:

1. Positive and negative income adjustments under Section 481(a).
2. Cancellation of indebtedness income and bad debt deductions.
3. Income and deductions reported under the completed contract method.
4. Income from sales or exchanges reported under the installment method.
5. The distributive share of partnership items of income, gain, loss, and deduction.

Partnership Problems

The treatment when an S corporation holds an interest in a partnership had been particularly nettlesome. The proposed regulations generally look through an S corporation's partnership interest to treat its distributive share of the partnership's items as recognized built-in gain or loss to the extent that the distributive share would have been treated as recognized built-in gain or loss had the items originated in, and been taken into account directly by, the S corporation.

However, if the S corporation disposes of the partnership interest during the recognition period, the amount treated as recognized built-in gain or loss on the disposition is adjusted to take into

Continued on Page 4

BUILT-IN GAINS Continued From Page 3

account amounts treated as recognized built-in gain or loss under the look-through rules. Furthermore, the look-through rules do not apply where the S corporation owns an interest in the partnership with a value less than $100,000, if that value represents less than a 10% interest in the partnership's capital and profits.

Inventory Relief

Another irksome issue under Section 1374 is the extent to which a taxpayer has built-in gain on conversion to S status based merely on its inventory. Some advisors had suggested that inventory would be included at its full retail value, spelling a very large built-in gain for any retailer converting to S status. Fortunately, the proposed regulations specify that the fair market value of a corporation's inventory on conversion to S status is the amount a willing buyer would pay a willing seller for the inventory at that time in a purchase of all the corporation's assets. In other words, a bulk inventory value is employed.

The preamble to the proposed regulations indicates that the Service is considering whether to adopt a safe harbor under which an S corporation's recognized built-in gain from inventory would equal the gross profit (*i.e.*, gross receipts less cost of goods sold and direct selling expenses) from one inventory turn after the first day of the recognition period, multiplied by a designated percentage (for costs that add value to the inventory but were not taken into account in determining the inventory's gross profit). Under this contemplated safe harbor, recognized built-in gain from inventory for the first year of the recognition period would equal the inventory's gross profit for that year divided by the number of inventory turns that year, multiplied by the designated percentage.

The number of inventory turns in the first year of the recognition period would equal the cost of goods sold for that year divided by that year's opening value using the first in, first out method. For last in, first out ("LIFO") taxpayers, no gross profits from inventory would be treated as recognized built-in gain until the taxpayer invaded LIFO layers in existence on the first day of the recognition period. The Service is seeking guidance on whether this safe harbor would be appropriate, what the designated percentage should be, how the rule should apply to LIFO taxpayers, and whether any alternative safe harbors should be developed.

Effective Date

While the proposed regulations are slated to be effective only after the date they are published as final regulations, and even then only in cases where the return for the year is filed pursuant to an S election made on or after that date, one can expect that the positions stated in the proposed regulations suggest Service positions that may be applied to S corporations that have already converted. In particular, many corporations that converted to S status notwithstanding trepidation over the inventory issue may actually wish to seek an adjustment of the built-in gain previously reported. While most converting corporations used a bulk inventory sale approach, it remains to be seen how those who were less aggressive will fare if they seek an adjustment or refund. ■