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Built-in Gains Regulations Finalized

by Robert W. Wood • San Francisco

Final regulations (T.D. 8579) were recently published under Section 1374 dealing with the built-in gain tax. Proposed regulations were released at the very end of 1992, and in large part the final regulations conform to those proposed rules. However, there are a number of changes that deserve mention.

The built-in gain tax, of course, is pertinent only for S corporations that were previously C corporations and that (except in the case of certain transitional rule corporations) converted to S status after 1986. The built-in gain tax imposes a corporate level tax on the S corporation for

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dispositions occurring within a ten-year recognition period following the corporation's conversion from C to S status. Significantly—a point that many practitioners tend to forget—the built-in gain tax can also apply in the case of assets that an S corporation acquires in a carryover basis transaction from a C corporation (even in the case of an S corporation that was *always* an S corporation).

Partial Years

One point that the final regulations address in response to comments to the proposed rules concerns partial years. In some cases, a C corporation will be on a fiscal year yet convert to S status, requiring a calendar year. Commentators requested guidance on the S corporation's net recognized built-in gain when the recognition period ends during a tax year (i.e., where the C corporation was on a fiscal year and changed to a calendar year as an S corporation, or because an S corporation acquired C corporation assets in a carryover basis transaction during a tax year). Under the final regulations, the pre-limitation amount for the year will be determined by a closing of the books at the end of the recognition period.

The final regulations also extend recognized built-in loss treatment for amounts properly deducted under Section 267(a)(2) or 404(a)(5) during the recognition period. An amount deducted under Section 267(a)(2) will be treated as a recognized built-in loss to the extent that both: (1) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (2) the amount is paid in the first two and one-half months of the recognition period, or is paid to an individual that owned less than 5% of the corporation's stock.

Likewise, the final regs state that an amount deducted under Section 404(a)(5) will be a recognized built-in loss if both: (1) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (2) the amount is not deductible under Section 267(a)(2).

481 Adjustments Add Partnership Items

Another area of confusion relates to Section 481(a) adjustments. The final regulations indicate that any such adjustment taken into account in the recognition period that prevents an omission or duplication of income or deduction will be a recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the regulations' principles for determining recognized built-in gain or loss.

Partnership items, which caused considerable controversy early on in the interpretation of the built-in gain tax, received treatment in both the proposed and final regulations. In general, a look-through approach is adopted, so that the character of items at the partnership level pass through to S corporation partners for purposes of applying the built-in gain tax. However, the final regulations modify the so-called small-interest exception to the look-through rules.

As modified, the small-interest exception to the look-through concept will generally apply for a tax year if the S corporation's interest in the partnership represents less than 10% of the partnership's profits and capital at all times during the tax year (and prior tax years) in the recognition period, and has a value less than $100,000 as of the beginning of the recognition period. However, if the S corporation contributes an asset to the partnership in the recognition period, and the S corporation held that asset as of the beginning of the recognition period, the fair market value of the S corporation's partnership interest as of the beginning of the recognition period will be determined as if the asset was contributed to the partnership before the beginning of the recognition period. In making this fair market value determination, the fair market value of the asset will be determined as of the beginning of the recognition period.

Inventory Valuation

Another controversial topic virtually from the enactment of the built-in gain tax in 1986 concerned inventory. With some corporations, a conversion from C to S status with substantially appreciated inventory gives rise to heightened sensitivity to the application of the tax on

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disposition of assets. The proposed regulations provided that the value of an S corporation's inventory on the first day of the ten year recognition period would be equal to the amount that a willing buyer would pay a willing seller for the inventory in the purchase of all of the S corporation's assets on that day. There was some controversy about whether this really implied a bulk sale concept or not.

The final regulations state that the value of an S corporation's inventory on the first day of the recognition period will generally be determined by reference to a sale of the *entire business* of the S corporation to a buyer that expects to continue to operate in that business. Thus, rather than focusing exclusively upon the inventory element, the applicable context for the valuation would be a gross sale of the business, of which the inventory would merely be one part. The final regulations state that in making this determination, the buyer and seller are presumed not to be under any compulsion to buy or sell, and to have reasonable knowledge of all relevant facts. *See* Reg. §1.1374-7(a).

Apart from valuation, the identity of inventory dispositions must also be addressed. The inventory method used by the S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period was held on the first day of that period. A LIFO method corporation, therefore, does not dispose of inventory it held on the first day of the ten year recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method). *See* Reg. §1.1374-7(b).

Effective Date

The final regulations under Section 1374 apply to tax years ending on or after December 27, 1994, but only in cases in which the return for the tax year is filed under an S election or a Section 1374(d)(8) transaction that occurs on or after that date. *See* Reg. §1.1374-10. As to the first element of this effective date, this means that the vast majority of S corporations that currently worry about the built-in gain tax (that is, those having elected S status on converting from C status within the last few years), the regulations do not apply. While the regulations would commence applying for calendar year S corporations in 1995, the S election would have to be filed on or after December 27, 1994 in order for the regulations to kick in.

As to the second element, the occurrence of a Section 1374(d)(8) transaction, however, some explanation is in order. The regulations define such a transaction as one in which an S corporation acquires any asset in which the S corporation's basis in the asset is determined in whole or in part by reference to a C corporation's basis in the asset. *See* Reg. §1.1374-8(a). Thus, for S corporations that converted to S status pursuant to an election filed prior to December 27, 1994, the new regulations can have effect with respect to such carryover basis transactions, but only commencing for tax years after that date (i.e., for 1995 and subsequent years).

The final regulations answer a number of important questions and give examples of their operation. While they do not solve all the issues arising under the built-in gain tax, they address most questions that practitioners are likely to have. ■

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