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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

TD 9210

RIN 1545-BE75

LIFO Recapture Under Section 1363(d)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

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

DATES: Effective Date: These regulations are effective July 12, 2005.

Applicability Date: These regulations apply to S elections and transfers made on or after August 13, 2004.

FOR FURTHER INFORMATION CONTACT: Pietro Canestrelli, at (202) 622-3060 and

Martin Schäffer, at (202) 622-3070 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1906.

The collection of information in these final regulations is in § 1.1363-2(e)(3). This information is required to inform the IRS of partnerships electing to increase the basis of inventory to reflect any amount included in a partner's income under section 1363(d).

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

Estimated total annual reporting burden: 200 hours.

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

Estimated number of respondents: 100.

Estimated annual frequency of responses: On occasion.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of

Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law.

Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## **Background**

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

Final regulations (TD 8567) under section 1363(d) were published in the **Federal Register** on October 7, 1994 (59 FR 51105) to describe the recapture of LIFO benefits when a C corporation that owns LIFO inventory elects to become an S corporation or transfers LIFO inventory to an S corporation in a nonrecognition transaction. The

regulations did not explicitly address the indirect ownership of inventory through a partnership.

A notice of proposed rulemaking (REG-149524-03, 2004-39 I.R.B. 528) was published in the **Federal Register** on August 13, 2004 (69 FR 50109). The proposed regulations provided guidance for situations in which a C corporation that owns LIFO inventory through a partnership (or through tiered partnerships) converts to an S corporation or transfers its partnership interest to an S corporation in a nonrecognition transaction. One person submitted comments in response to the notice of proposed rulemaking. A public hearing was held on December 8, 2004. After consideration of the comments, the proposed regulations are adopted as final regulations with the modifications discussed below.

### **Summary of Comments and Explanation of Revisions**

The proposed regulations provided that a C corporation that holds an interest in a partnership owning LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership to an S corporation in a nonrecognition transaction. The proposed regulations defined the lookthrough LIFO recapture amount as the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the FIFO value. A corporate partner's lookthrough LIFO recapture amount must be determined, in general, as of the day before the effective date of the S corporation election or, if the recapture event is a transfer

of a partnership interest to an S corporation, the date of the transfer (the recapture date). The proposed regulations provided that, if a partnership is not otherwise required to determine inventory values on the recapture date, the lookthrough LIFO recapture amount may be determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date.

The sole commentator suggested that the regulations provide that, if the lookthrough LIFO recapture amount is determined based on inventory values of the partnership's opening inventory for the year that includes the recapture date, then the lookthrough LIFO recapture amount must be adjusted to take into account any adjustments to the partnership's basis in its LIFO inventory that result from transactions occurring during the period from the start of the partnership's tax year to the end of the recapture date. Thus, the lookthrough LIFO recapture amount would have to reflect any adjustments to the basis of LIFO inventory during that period under sections 734(b), 737(c), or 751(b). The final regulations adopt this suggestion.

The proposed regulations provided that a corporation owning LIFO inventory through a partnership must increase its basis in its partnership interest by the lookthrough LIFO recapture amount. The proposed regulations also allowed the partnership through which the LIFO inventory is owned to elect to adjust the basis of partnership inventory (or lookthrough partnership interests held by that partnership) to account for LIFO recapture. This adjustment to basis is patterned in manner and effect after the adjustment in section 743(b). Thus, the basis adjustment constitutes an adjustment to the basis of the LIFO

inventory (or lookthrough partnership interests held by that partnership) with respect to the corporate partner only; no adjustment is made to the partnership's common basis.

The Treasury Department and the IRS requested comments on whether the partnership should be required, in some or all circumstances, to increase the basis of partnership assets by the lookthrough LIFO recapture amount attributable to those assets. No comments were received on this question. Therefore, the final regulations follow the rule of the proposed regulations.

The sole commentator recommended that the regulations should extend the availability of a section 743(b)-type basis adjustment to the purchase of a lookthrough partnership interest by a C corporation that subsequently makes an S election (or subsequently disposes of the partnership interest in a nontaxable carryover basis transaction). It has been determined that this recommendation is beyond the scope of the regulations and, so, is not included in the final regulations.

The commentator recommended that the regulations provide for the retroactive revaluation of LIFO inventories under § 1.704-1(b)(2)(iv)(f) when a non-C corporation partner has been admitted to a partnership (or the non-C-corporation partner's relative interest in the partnership has increased) within a period of two years 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). It has been determined that this recommendation is beyond the scope of the regulations and, so, is not included in the final regulations.

Regarding the payment of the LIFO recapture tax during an S year, the commentator made two suggestions. First, notwithstanding section 1371(c)(1), the regulations should provide that the S corporation's earnings and profits be reduced upon such a payment. Second, notwithstanding section 1367(a)(2)(D), the regulations should provide that the stock basis of the shareholders of the S corporation not be reduced upon such a payment. The 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.

Finally, the commentator questioned whether it is appropriate to issue these regulations under the authority of section 337(d). The Treasury Department and the IRS continue to believe that issuing these regulations under the authority of section 337(d) is appropriate, because Congress's purpose in enacting section 1363(d) was to prevent taxpayers owning LIFO inventory from avoiding the built-in gain rules of section 1374. H.R. Rep. No. 100-391 (Parts 1 and 2), 1098 (1987).

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866; therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few corporations engage in the type of transactions that are subject to these regulations (the conversion from C corporation to S corporation status while holding an interest in a

partnership that owns LIFO inventory or the transfer of an interest in such a partnership by a C corporation to an S corporation in a nonrecognition transaction). Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. These final regulations are necessary to prevent abusive transactions involving partnerships and S corporations. Accordingly, good cause is found for dispensing with a delayed effective date pursuant to 5 U.S.C. 553(d)(3). Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

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

### **List of Subjects**

#### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### 26 CFR Part 602

Reporting and recordkeeping requirements.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

## PART 1--INCOME TAXES

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

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

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

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

1. Redesignating paragraphs (b), (c), and (d) as paragraphs (d), (e), and (g), respectively.

2. Adding new paragraphs (b), (c), (f), and (g)(3).

3. Revising newly designated paragraphs (d) and (e).

The revision and addition read as follows:

§1.1363-2 Recapture of LIFO benefits.

\* \* \* \* \*

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

(c) Definitions and special rules--(1) Recapture date. In the case of a transaction described in paragraph (a)(1) or (b)(1) of this section, the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (a)(2) or (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation.

(2) Determination of LIFO recapture amount. The LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (a)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (a)(2) of this section.

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

(4) Lookthrough LIFO recapture amount--(i) In general. For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704-3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in,

first-out method of accounting authorized by section 471, determined in accordance with section 1363(d)(4)(C).

(ii) Determination of lookthrough LIFO recapture amount. Except as provided in paragraph (c)(4)(iii) of this section, the lookthrough LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (b)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (b)(2) of this section.

(iii) 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).

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

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

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

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

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

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

(3) Election. A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under 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.

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

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

(ii) Under paragraph (c)(4)(iii) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(4) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value (\$200) exceeds the LIFO value (\$120) in GH's opening inventory is \$80. Thus, if GH sold all of its LIFO inventory for \$200, it would recognize \$80 of income. G's lookthrough LIFO recapture amount is \$80, the amount of income that would be allocated to G, taking into account section 704(c) and §1.704-3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include \$80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by \$80. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by \$80.

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

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

must increase its basis in its interest in JK by \$30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by \$30.

(g) \* \* \*

(3) The provisions of paragraphs (b), (c), (d), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004. The rules that apply to S elections and transfers made before August 13, 2004, are contained in §1.1363-2 as in effect prior to August 13, 2004 (see 26 CFR part 1 revised as of April 1, 2005).

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

\*\*\*\*\*

(b)\*\*\*

CFR part or section where identified and described	Current OMB control No.
*****	
1.1363-2 .....	1545-1906
*****	

Deputy Commissioner for Services and Enforcement.

Approved:

Acting Deputy Assistant Secretary of the Treasury.