Internal Revenue Service

Department of the Treasury

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CC:CORP:B05-PLR-142298-01
Date:
October 31, 2001

LEGEND:

Company =

Minerals =

State X =

Date 1 =

Date 2 =

a =

Dear :

This letter responds to your August 2, 2001 request for a ruling on behalf of Company regarding the proper treatment of income recognized from the sale of certain Minerals during the 10-year recognition period under § 1374 of the Internal Revenue Code of 1986, as amended ("Code"). Additional information was received in a letter dated October 2, 2001. The material information is summarized below.

Company, a C corporation organized on Date 1 under the laws of State X, owns a quarry in fee simple. Company's business operations consist of mining and processing crushed Minerals from its quarry. Company is not in the business of selling its unmined property to customers to extract and process Minerals.

Company computes its federal income tax liability using an accrual method of accounting and files its federal income tax returns on a calendar year basis. Company has one class of stock and less than 75 shareholders. Company proposes to make an

election to be taxed as an S corporation within the meaning of § 1361 (“Election”) effective for tax years beginning on Date 2. On the effective date of Company’s Election (“Conversion Date”), approximately a % of the quarry will still contain unmined Minerals.

Company requests a ruling that income from dispositions of crushed Minerals, that are mined and processed after the Conversion Date, during the recognition period will not constitute recognized built-in gain within the meaning of § 1374(d)(3) of the Code.

Section 1374(a) imposes a corporate-level tax on an S corporation's net recognized built-in gain during the recognition period (generally 10 years) following (a) a C corporation's conversion to S corporation status or (b) an S corporation’s acquisition of assets in a transaction in which the S corporation’s basis in the acquired assets is determined by reference to the basis of such assets in the hands of a C corporation.

Section 1374(d)(2) provides that an S corporation's net recognized built-in gain for any tax year is generally its taxable income for the year computed as if it was a C corporation, but taking into account only items treated as recognized built-in gain or recognized built-in loss.

Section 1374(d)(3) provides that recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation shows that (a) it did not hold the asset on the Conversion Date, or (b) the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the Conversion Date.

Section 1.1374-4(a) of the Income Tax Regulations provides that § 1374(d)(3) applies to any gain or loss recognized during the recognition period in a transaction that is treated as a sale or exchange for federal tax purposes.

In Example 1 of § 1.1374-4(a)(3), X is a C corporation that converts to an S corporation effective January 1, 1996. On the conversion date, X owns a working interest in an oil and gas property on which production of oil has not yet begun, and the fair market value of the working interest exceeds X's adjusted basis in the working interest by $200,000. During the recognition period, X produces and sells oil from the working interest, and includes $75,000 in income on the sale. X's $75,000 of income is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property and not the oil itself since the oil had not yet been extracted from the ground.

Rev. Rul. 2001-50, 2001-43 I.R.B. 343 (Oct. 22, 2001) provides that if an S corporation that holds timber property on the conversion date cuts the timber and sells the resulting wood products during the recognition period, in a transaction to which

§ 631 does not apply, the tax consequences to the S corporation under § 1374 are determined using the same analysis contained in Example 1 of § 1.1374-4(a)(3). Under Rev. Rul. 2001-50 such wood products sold as inventory during the recognition period do not constitute separate assets held by an S corporation on the conversion date and thus their production and sale do not constitute a partial disposition of the timber property. Accordingly, the S corporation's income on the sale of the resulting wood products during the recognition period is not recognized built-in gain within the meaning of § 1374(d)(3).

Based solely on the information submitted and on the authority set forth above, we rule that income from dispositions by Company of crushed Minerals, that are mined and processed after the Conversion Date, during the recognition period will not constitute recognized built-in gain within the meaning of § 1374(d)(3) of the Code.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above ruling. In particular, no opinion is expressed about the tax treatment of income that may be realized by Company during the recognition period under § 1374 of the Code, other than income from the disposition of crushed Minerals mined after the Conversion Date.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to Company's federal income tax returns for Company's final tax year as a C corporation and for each recognition period year in which a disposition of crushed Minerals occurs.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to the second representative listed on that power of attorney and to the taxpayer.

Sincerely,
John P. Moriarty
Assistant to the Branch Chief, Branch 5
Office of Associate Chief Counsel
(Corporate)