

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

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ID No.
Telephone Number:

Attn:

Refer Reply To:
CC:ITA:6
PLR-144366-09
Date:
November 20, 2009

DO:

TY:

LEGEND:

Proprietorship =
Year 1 =
Brand =
Product =
Number =
Raw Materials =

Dear _____ :

We received your application of August 25, 2009, which asks us to rule that § 1363(d) of the Code does not apply when: (1) a sole proprietorship using the LIFO inventory method transfers its assets to a newly formed corporation in a transaction that meets the requirements of § 351; (2) that corporation timely files an election to use the LIFO inventory method for the first year of its existence; and (3) that corporation timely elects to be an S corporation for the first year of its existence.

The following facts have been obtained from the above-referenced application. Operating as a sole proprietorship since Year 1, Proprietorship manufactures the Brand brand of Product and distributes it in Number states and select international destinations. Proprietorship manufactures Product from Raw Materials produced by the

taxpayers and from Raw Materials purchased from unrelated parties. Proprietorship is headed by the taxpayers, with assistance from their sons.

Proprietorship uses a modified cash method of accounting. Specifically, Proprietorship uses an accrual method for inventory-production costs and the cash method for all other activities of the business. In addition, Proprietorship uses the LIFO inventory method and complies with the uniform capitalization rules of § 263A.

Law

Section 1363(d) provides generally that if an S corporation was a C corporation for the last tax year before the first tax year for which an election to be taxed as an S corporation was effective, and the corporation inventoried goods under the LIFO method for such last tax year, the LIFO recapture amount shall be included in the gross income of the corporation for such last tax year. The “LIFO recapture amount” is the amount (if any) by which the inventory amount of the inventory asset under the FIFO method authorized by section 471 exceeds the inventory amount of such assets under the LIFO method. The “inventory amount” [carrying value] of assets under a method authorized by section 471 shall be determined using the retail method or, if the corporation does not use the retail method, by using cost or market, whichever is lower.

Analysis

Section 1363(d) mandates the taxation of the LIFO recapture amount if an S corporation was a C corporation for the last taxable year before the first taxable year for which an S corporation election was effective. Reading the words of section 1363(d) literally, we conclude that it does not apply to the facts presented by the taxpayers. Proprietorship has never been a C corporation, and the corporation to be formed by the taxpayers will elect to be an S corporation for the first year of its existence.

Our literal reading of section 1363(d) in this case does not thwart congressional intent. Congress enacted a related provision, section 1374, to tax an S corporation on the built-in gains attributable to the period when it was a C corporation. Section 1374 applies, however, only to built-in gains recognized during the first 10 years of the corporation’s existence as an S corporation (“10-year recognition period”). Because of the mechanics of the LIFO inventory method, the built-in gains from LIFO inventories will not be fully recognized until the taxpayer experiences a decrement in every inventory layer that existed on the date the C corporation elected to be an S corporation. It is possible, even likely, that the S corporation will not experience a decrement in any of these inventory layers during the 10-year recognition period and, thus, will escape taxation under section 1374 altogether. This result gives an S corporation using the LIFO inventory method a tax-based competitive advantage over an S corporation using the FIFO inventory method. To counter this result, Congress enacted section 1363(d), which prevents an S corporation from avoiding the taxation of

any built-in gains attributable to LIFO inventories held when it was a C corporation. See H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 974 (1987). We do not believe Congress intended section 1363(d) to apply when avoidance of the built-in gain rules of section 1374 is not possible and, thus, cannot be one of the goals of the corporation's election to be an S corporation. The existence of built-in gain subject to section 1374 is not possible in this case for the same reasons that section 1363(d) literally does not apply to the facts of this case.

Conclusion

Accordingly, based solely on the information and representations submitted by the taxpayers (and accompanied by a penalty of perjury statement executed by an appropriate party), it is held that section 1363(d) does not apply when: (1) a sole proprietorship using the LIFO inventory method transfers its assets to a newly formed corporation in a transaction that meets the requirements of § 351; (2) that corporation timely files an election to use the LIFO inventory method for the first year of its existence; and (3) that corporation timely elects to be an S corporation for the first year of its existence.

No opinion is expressed as to the application of any other provisions of the Code or the regulations which may be applicable to the transaction. Specifically, no opinion is expressed regarding the propriety of the LIFO inventory methods used by the taxpayer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Though this office has not verified any of the information and representations submitted by the taxpayers, those items are subject to verification on examination.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayers' authorized representatives.

Please contact the person whose name and telephone number are shown above if you have any questions.

Sincerely,

Jeffery G. Mitchell
Branch Chief, Branch 6
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: