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Pre-Release Comments on the Built-In Gains Tax Regulations

American Institute of Certified Public Accountants. S Corporation Taxation Committee. Section 1374 Working Group

Tax Division

of the

American Institute of Certified Public Accountants

S Corporation Taxation Committee

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Mr. Nelson Crouch
Branch Chief
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Dear Mr. Crouch:

Since enactment of the Built-in Gains Tax (Section 1374) in 1986, the Tax Division of the American Institute of Certified Public Accountants has been concerned with certain technical issues that arise when the law is applied in practice. The AICPA's S Corporation Taxation Committee has prepared the enclosed outline of recommendations for your use as you and your staff draft regulations in this area.

We have organized our comments under the following topics:

- valuation of inventory,
- partnership issues,
- built-in gain/loss definition issues, and
- miscellaneous issues.

These comments include what we consider to be the most critical issues that should be addressed in the Section 1374 regulations. They by no means address all of our concerns.

If you have any questions regarding these recommendations, please contact one of the following individuals:

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Sincerely,

Arthur S. Hoffman

Arthur S. Hoffman
Chairman, Federal Taxation Executive Committee

Enclosure

cc: Mark Jennings
Greg Marich
Roy Strowd

I. Valuation of Inventory

The issues surrounding the method of valuing inventory for built-in gain purposes under IRC §1374 are of great concern to practitioners. Inventories are a factor in a great many businesses, large and small. There is a need for certainty and a practical method of determining such value.

We recommend that the determination of fair market value of inventory be made by valuing the inventory on an item-by-item basis according to the concepts of "market" as provided in the regulations under §471. In general, this will represent the aggregate fair market value of each of the items in the inventory, thus meeting the requirements of §1374 that the fair market value of the assets of the business be compared with the tax basis. Further, this is consistent with the §1374(d)(3) requirement for computing recognized built-in gain on the disposition of each asset. At the very least a safe harbor should be provided to those taxpayers making a good faith effort to value inventories under the §471 concepts of "market."

"Net unrealized built-in gain" under §1374 is determined by reference to "fair market value" of the assets of the S corporation. Accountants have long been concerned with the "market" value of inventories in connection with the determination of "market" for valuing inventories at "cost or market, whichever is lower." For these purposes, "market" means current replacement cost (by purchase or reproduction, as the case may be) except that:

- Market shall not exceed the net realizable value (i.e. estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal); and

- Market shall not be less than net realizable value reduced by an allowance for an approximately normal profit margin (FASB Accounting Standards, Current Text, Volume I, Section I78.110).

Thus, "market" value determinations are made on an item-by-item basis. Such determinations of "market" are routinely made by accountants in hundreds of thousands of different companies involving nearly every conceivable business activity.

Admittedly, "market" for accounting purposes is not necessarily the same as "fair market value" for tax purposes. Accounting concepts are primarily concerned with assigning costs to the appropriate period and matching costs to the applicable revenue. However, replacement or reproduction costs generally approximate the fair market value of individual items and the floor and ceiling provisions generally recognize the value limits to a particular "willing buyer," that is, a particular buyer will not pay more than net realizable value and will be willing to pay at least as much as will allow it to return a normal profit margin.

Utilization of the cost or market, whichever is lower, method of inventory valuation is permitted for tax purposes under Reg. §1.471-2. Market for this purpose is defined in Reg. §1.471-4. These regulations also adopt the primary rule of replacement or reproduction cost. However, the ceiling and floor exceptions are much different. The ceiling of net realizable value is applied only under very restrictive conditions and the floor of net realizable value reduced by an allowance for an approximately normal profit margin is not recognized at all. A general summary of these rules is as follows:

- Reg. §1.471-4(a) defines market to mean ordinarily, "the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer."

- The Courts have uniformly interpreted "bid price" to mean replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items. (Thor Power Tool Co. v. Commissioner, 439 US 522 (1979), 79-1 USTC ¶9139).

- Replacement prices should be based on bid prices prevailing in the particular market in which the taxpayer normally purchases its goods. (E.T. Bamert, 8 B.T.A. 1099 (1927); D. Loveman & Son Export Corp., 34 T.C. 776 (1960) aff'd per curiam 296 F. 2d 732 (6th cir 1962), 62-1 USTC ¶9147; IRS Ltr. Rul. No. 8022011).

- Replacement cost is applicable to goods purchased, and to the basic elements of cost (materials, labor and burden) for goods in process of manufacture or finished goods (generally reproduction cost). (Reg. §1.471-4(a)).

- The IRS's position is that replacement cost should be used for any purchased or produced goods in the inventory of a manufacturer that are in a form saleable on the open market. Goods which have moved into process to a further state of manufacture but which have not reached a form saleable on the open market, should be valued at current bid prices for goods of the preceding saleable form plus the necessary labor and burden attaching up to the state in which the goods are found on the inventory date. (GCM 9401, X-1 CB 102 (1931); GCM 38906, October 6, 1982).

- Where no open market exists, Reg. §1.471-4(b) requires the taxpayer to ascertain "bid price" by using "such evidence of the fair market price at the date or dates nearest the inventory as may be available, . . ."

- The taxpayer is permitted to value inventory below the replacement cost if the taxpayer in the normal course of business has actually offered merchandise for sale at prices lower than the replacement cost. The inventory of such merchandise may be valued at those prices less direct cost of disposition (net realizable value). (Reg. §1.471-4(b)).

- For subnormal goods the taxpayer is permitted to value the goods at "bona fide selling prices less direct costs of disposition." "Bona fide selling price" means an actual offering of goods during a period ending not later than 30 days after inventory date. Raw materials and partly finished goods should be valued on a reasonable basis, but no less than scrap value. (Reg. §1.471-2(c)).

- Uniform capitalization rules must be considered if market is based on replacement cost but not if it is based on the selling price. (Notice 88-86, 1988-2 CB 401).

- The taxpayer must compare the cost of each item in the inventory to the market. (Reg. §1.471-4(c)).

(See generally, Schneider, Federal Income Taxation of Inventories, Chapter 7).

The fair market value of inventory has been considered by the Tax Court in The Zeropack Company v. Commissioner 47 TCM 181 (1983) and by the Court of Claims in Knapp King-Size Corp. v. U.S., (Ct. Cl. 1975) 527 F. 2d 1392, 76-1 USTC ¶9128 and Jack Daniels Distillery v. U.S., 379 F. 2d 569 (Ct. Cl. 1967) 67-2 USTC ¶9499. The Federal District Court in Wisconsin considered the issue in Berg v. U.S., 167 F. Supp. 756 (DC Wis 1958), 58-2 USTC ¶9937. These cases seem to add more confusion than enlightenment to the problem.

The Berg case involved the valuation of a manufacturer's inventory on liquidation of a corporation. The Court used net realizable value for finished goods and replacement or reproduction cost, less 10% for selling and marketing expense, for raw materials and semifinished goods. The Court rejected reproduction cost for finished goods because of the time necessary to replace the inventory.

Zeropack, Knapp King-Size and Jack Daniels Distillery are all cases involving the allocation of a lump-sum purchase price to the various assets of an acquired business. Jack Daniels Distillery involved inventory which was considered irreplaceable and for which there was no open market. It can be reconciled to Reg. §1.471-4 on that basis, that is, using the best evidence available. The method used was to start with the case price of bottled whiskey and then deduct excise taxes, bottling costs, and other charges not yet incurred with respect to bulk inventory. This was the calculated value of matured whiskey in barrels and bottling tanks. The value of freshly distilled whiskey was estimated at production cost. The difference between these two values was prorated to get the value of intermediate age whiskey.

Zeropack and Knapp King-Size involved wholesale and retail businesses. No evidence of replacement cost was presented because the taxpayers were contending that the retail value was proper. The Courts in both cases rejected the retail value. In arriving at the appropriate value, the Courts started with retail value, then deducted disposition and handling costs during the disposition period. The next step was to estimate the profit and make a judgement about the allocation of profit between the buyer and seller. The portion considered to be allocable to the buyer was also deducted from the retail value. The Court in Knapp King-Size observed that the starting point should have been replacement cost.

Rev. Proc. 77-12, 1977-1 C.B. 569 provides guidelines for making inventory fair market value determinations in situations where a corporation purchases the assets of a business for a lump sum or where a corporation acquires stock and liquidates a subsidiary under former §334(b)(2). This Revenue Procedure generally recognizes that replacement cost is appropriate for retail and wholesale inventories, but also states that a premium or discount from replacement cost may be appropriate in particular circumstances. Replacement cost is deemed appropriate for raw materials of maufacturers, but the "comparative sales method" or the "income method" is suggested for determining the value of finished goods inventory of manufacturers and for work in process. These methods involve the discounting of expected selling prices for additional costs and handling charges and the allocation of the expected profit between the buyer and seller.

The difficulty with Rev. Proc. 77-12 and the decided cases is that very little certainty is provided and that all valuation methods are judgemental, thus making third-party appraisals necessary to establish values. With respect to inventories, qualified appraisers are often difficult to find, thus making compliance difficult. Further, these authorities only deal with the valuation of inventory in a bulk sale situation. In most cases, businesses trying to cope with §1374 will not be concerned with a bulk sale of inventory, but rather with the sale of individual units from that inventory and the need to determine the built-in gain applicable to the sale of each unit or a representative sample of units.

Reg. §1.751-1(d)(1) concerning substantially appreciated inventory, provides that "fair market value" of inventory items has the same meaning as "market" value in the regulations under §471.

The cases of Zeropack, Knapp King-Size, Jack Daniels Distillery, and Berg and also Rev. Proc. 77-12 are concerned with the valuation of inventory as one unit or one asset, and not as an aggregation of the individual values of the units of inventory. Thus, a premium or discount may be appropriate because of the value or lack of value of the inventory units when assembled together in a particular location as a part of a particular business. The value of the whole may be more or less than the value of the individual parts of the inventory. If it is felt necessary to consider this premium or discount for purposes of §1374 then it should be recognized that such gain or loss is realized only if the inventory is sold in bulk. As individual items in the inventory are sold and replaced, the value or lack of value continues and is not realized. Therefore, built-in gain or loss attributable to the sale of individual inventory items should generally be determined based on the replacement cost of that particular item on the conversion date.

In summary, we believe that in order to provide a workable, administrable system of determining the built-in gain attributable to inventory, the regulations should:

- provide a valuation system which can be calculated by accountants and small businesses without the necessity of engaging outside professional appraisers;
- utilize the concept of "market" value provided in the regulations under §471, which will predominantly be replacement or reproduction cost;
- disregard the consideration of premium or discounts applicable to the inventory as a whole, only taking them into consideration in the event of a bulk sale or other disposition of substantially all of the inventory.

II. Partnership Issues

If a C corporation is a partner in a partnership on the date that it converts to S status, should the corporation's share of the assets of the partnership be treated as subchapter C assets for purposes of the built-in gains tax under §1374? If regulations provide that the answer to this question is affirmative, the S corporation's distributive share of income or gain resulting from the disposition of any asset held by the partnership on the date the corporate partner became an S corporation (or other income recognition event attributable to the period of time prior to the date of the corporation becoming an S corporation) would be treated as a recognized built-in gain of the S corporation partner.

This problem is another example of the conflict between the entity theory and the aggregate theory under subchapter K of the Internal Revenue Code. It is recognized that the conceptually correct approach would be to apply the aggregate theory in the context of the application of the built-in gains tax to the assets of the S corporation held through a partnership. Failure to utilize an aggregate approach could clearly lead to abuse in certain situations. For example, under an entity theory, an S corporation could contribute its subchapter C assets to a partnership (formed, for example, with the shareholders of the S corporation as the other partners), and the partnership could then one-by-one dispose of its assets without having the S corporation treat its distributive share of the resulting gain as recognized built-in gain. The S corporation would be free to argue that it continued to hold a partnership interest and since such partnership interest was not disposed of by the S corporation, no built-in gains tax applies. We believe that rules should be written to foreclose this abuse potential.

This perceived abuse could be corrected by adopting an aggregate approach (i.e., treating the S corporation as holding the assets of the partnership) or, as has been suggested by others, by treating the S corporation's distributive share of gain on disposition by the partnership as a built-in gain item (income attributable to prior C existence). However, we feel that there are compelling reasons for not blindly adopting either of these two approaches with respect to all partnership interests held by S corporations.

We believe that either approach would impose administrative burdens on many non-abusive partnerships and S corporations. These administrative burdens would result from the fact that every partnership would be required to continually keep track of its partners and determine which of its corporate partners are S corporations. If the partnership determined that it had an S corporation partner, regardless of its proportionate ownership in the partnership, it would need to know the date that such partner became an S corporation. It must then track the assets it held on that date, and its basis and fair market value in those assets at that time. If the partnership has a §754 election in effect, it would be required to determine the amount, if any, of the S corporation-partner's special basis adjustment in the relevant assets. All of this information would have to be maintained by the partnership because under Reg. §1.702-1(a)(8)(ii): "each partner must take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately."

It is clear that many larger partnerships with numerous partners, each holding a small interest, cannot hope to comply with these requirements. Therefore, we suggest an alternative that would recognize a safe harbor that would protect both partnerships and S corporations (with de minimus partnership interests) from administrative burdens in nonabusive situations. On the other hand, we recognize that where an S corporation holds a substantial interest in a partnership, the partnership should accept an administrative burden, particularly in cases where the S corporation recently acquired its partnership interest or recently contributed assets to the partnership.

Therefore, we suggest inclusion of the following rules. In all cases, attribution rules similar to those in §318 would apply in determining ownership by the S corporation.

1. <u>For partnerships in which an S corporation holds a 20 percent or greater interest in the partnership</u>: An aggregate approach should be used with respect to that S corporation partner because, in such cases, the requisite flow of information between the partnership and its 20 percent or greater partner should be fairly easily accomplished without undue administrative problems. Therefore, a disposition of partnership assets could trigger a built-in gain at the S corporation partner level. As an alternative, the S corporation partner should be allowed to elect to treat its distributive share of income as built-in gain until all built-in gains from that partnership are recognized.

2. For partnerships in which an S corporation holds an interest of less than 20 percent in the partnership: An entity approach would generally be used, meaning that the potential subchapter C asset would be the partnership interest rather than the underlying assets. A built-in gains tax exposure would only arise when the S corporation itself disposed of its partnership interest. However, this rule would not apply to assets contributed by the S corporation to the partnership. The entity appraoch should only apply to partnership assets not contributed by the S corporation partner.

III. Built-in Gain/Loss Definition Issues

A. What is a Disposition for Built-in Gain/Loss Purposes?

1. Wasting Assets

Wasting assets are items such as favorable leaseholds, licensing agreements, and other favorable contract arrangements. Where the fair market value of these assets on the date of conversion to S corporation status exceeds basis, there is the potential for recognition of built-in gain upon disposition of the asset. However, it is unclear what constitutes a disposition for this purpose.

We believe the use of a wasting asset should not be considered a disposition. Built-in gain or loss should only occur upon sale of the asset to an unrelated third party or upon an income recognition event. Moreover, if Treasury believes the use of property is a recognition event, a rule of administrative convenience should be adopted to not treat the use of property as a recognition event. Without such a rule, the valuation and recordkeeping burden on both taxpayers and the IRS would be excessive.

2. Expensed Amounts

An entity may have properly expensed certain amounts under its method of accounting during its C corporation existence that provide a benefit during an S corporation year. Examples include:

- The unexpired portion of a one-year insurance premium, and

- Supplies that were expensed in a C corporation year but used or consumed during the recognition period.

As with the wasting assets, we believe the use of these items should not generate built-in gain during the recognition period. However, the sale of a previously expensed item or the recovery of a previously expensed amount should be considered a recognition event which should trigger a built-in gains tax.

B. Built-in Losses and Contingent Liabilities

An example is a toxic waste dump site where the land could not be sold until the owner escrowed clean-up funds with a government agent. Such a contingent amount should reduce the value of the asset. The regulations should clarify that a contingent liability such as warranty claims, lawsuits and similar items are built-in items similar to those described in §1374(d)(5)(B) if they would be deductible when paid, or if they would reduce the value of a specific asset (as in the toxic waste site example).

C. Computation Issues

1. Capital and Built-In Gains in Same Year

Both the capital gains tax and built-in gains tax under former and current §1374 utilize a taxable income limitation in determining the amount of gain subject to tax in any recognition year. The purpose of this taxable income limitation is to impose a tax only if the taxpayer has the wherewithal to pay. However, there is no coordination between old and new §1374 when applying the taxable income limitation for transition corporations subject to both taxes, thus creating potential situations where the same dollar of taxable income is subject to both taxes.

For example, assume that a transition corporation has the following activity in a recognition year:

§1245 gain (subject to the BIG tax)	$ 100,000
§1231 gain (subject to the CG tax)	200,000
Loss from operations	(50,000)
Taxable income	$ 250,000

Under current law, the capital gains tax will be assessed on $175,000 ($200,000 - 25,000 exclusion). In addition, the built-in gains tax could potentially be assessed on all $100,000 of the recognized built-in gain. As a result, $275,000 of gain would be subject to the capital or built-in gains tax, $25,000 more than the corporation has in taxable income.

Recommendation: The regulations should provide that any gain subject to old §1374 tax (determined without the $25,000 exclusion provided in old §1374(b)(1)) is deducted from taxable income in determining the limitation under new §1374(d)(2). As a result, in the above example, the built-in gains tax would be assessed on $50,000 ($250,000 -$200,000), with the $50,000 in untaxed gain carried forward under §1374(d)(2)(D).

2. Passive Income and Built-in Gains Tax in Same Year

A similar situation arises when applying the taxable income limitation in a year that an S corporation has both recognized built-in gains under §1374 and a passive investment income tax liability under §1375.

Passive income		$ 120,000
Nonpassive built-in gain		200,000
Loss from operations		(100,000)
Taxable income		$ 220,000
Gross receipts	=	$ 320,000
Excess net passive income (ENPI)	=	$ 40,000

Under current law, the §1375 tax is computed on $40,000 ENPI, and the built-in gains tax would be applied on $200,000 in gain.

Recommendation: The regulations should provide in a case where a tax is incurred under §1375 and the corporation's taxable income is less than the combined recognized built-in gain and ENPI, the amount of built-in gain subject to the tax is taxable income reduced by ENPI and any excess of built-in gain over this amount is subject to carryover under Section 1374(d)(2)(B). Otherwise, part of the loss from operations is permanently lost. If this approach is applied to the above example, the BIG tax would be computed on $180,000 ($220,000 - $40,000).

IV. Miscellaneous Issues

A. Characterization of Built-in Losses

1. In situations where a corporation has recognized built-in gains and losses of different character in a post-conversion year, it is unclear whether recognized built-in capital losses may only offset recognized built-in capital gains.

   The regulations should clarify whether the definition of "net recognized built-in gain" will apply §1212(a)(1) limitations (including carryback and carryforward provisions for purposes of §1374 only), i.e., built-in losses on disposition of capital assets may only offset built-in gains from capital assets for purposes of §1374(d)(2) but net built-in capital losses may be carried back three years and forward five years.

2. The Revenue Reconciliation Act of 1989 modified §1366(f)(2) by stating that in a post-conversion period, the payment of any built-in gains tax would be treated as a built-in loss in the same character as the gain which gave rise to the tax. This change was added to allow deductions in situtations where the taxable income limitation had postponed imposition of the tax into a year later than the year the gain was recognized by the corporation for regular tax purposes.

   The problem with this correction is that the deduction in the year paid may end up being a capital loss, and therefore may not be fully deductible when passed-through to the shareholders, even though a capital gain generated the tax and had been recognized by the shareholders in a preceding year.

   To solve this problem, we recommend that the regulations follow the treatment explained in 1. above, allowing the shareholders to carry back the capital loss to open years to recover the tax they paid on the capital gains that had previously passed-through.

B. Accounting Method for Taxable Income Limitation

The §1374(d)(2)(A)(ii) taxable income limitation should be computed using the S corporation's accounting period and method, i.e., without regard to an accrual method that might be required had the corporation continued reporting as a C corporation under §448(a)(1). In the interest of simplification and administrative ease, the regulations should adopt this approach.

C. Tax Reform Act of 1986 Section 633(d) Transitional Rule

1. Clarify the determination of the taxable income limitation under former §1374 by use of an example similar to the following:

   a. Example: Calendar year C corporation elected S status December, 1987 effective January 1, 1988. 1988 taxable income equals $325,000, including built-in gain items of $75,000 ordinary income, $6,000 short-term capital gain and $175,000 long-term capital gain.

Built-in gains tax assuming "qualified corporation" with "applicable value" of (i) $1,000,000 (ii) $6,000,000.

(i)	1986 Code tax (34% X $81,000)	=	$27,540
	1954 Code tax (34% X $150,000)	=	51,000
	Total §1374 tax		$78,540
(ii)	1986 Code tax (34% X $116,000) (20% of LTCG included in $116,000)	=	$39,440

The remaining $140,000 LTCG is less than 50% of $325,000 taxable income. The regulations should provide that only 80% of taxable income should be considered for purposes of 1954 Code tax where only 80% of LTCG is subject to 1954 Code provisions.

Result: $140,000 LTCG exceeds 50% of $260,000 and 1954 Code tax 34% X $115,000	=	39,100
Total §1374 tax		$78,540

2. Specify that long-term capital gain property status is determined at corporate level for purposes of 1954 Code §1374.

D. Receipt of Assets with a Carryover Basis

1. Allocate the fair market value of the assets received using the principles of the §1060/338 regulations as if the business had been purchased at its fair market value on the date of transfer.

2. Clarify that carryovers from C corporations in a §381 transaction are not limited to built-in gains relating to the assets of such former C corporation.

3. Built-in gains and losses carried over in a §381 transaction should be aggregated with other built-in gains and losses rather than accounted for separately during the remaining recognition period.