by obtaining and exercising management rights in portfolio companies is the most likely option. The right to designate members of the board of directors of portfolio companies is most desirable, but other rights frequently obtained by investors in venture capital and leveraged buyout situations (e.g., rights to inspect corporate records at any time, receive all financial reports, and meet with and advise management) also may qualify. To avoid problems created by a recent Department of Labor advisory opinion, most partnerships seeking to qualify as VCOCs are closing in escrow or not taking down investors' contributions until they are ready to make their first investment.[105] On the other hand, for securities partnerships that do not anticipate being able to qualify for the venture capital operating company exemption, limiting ownership by benefit plan investors of any class of partnership interests to less than 25 percent of that class (disregarding all interests owned by the sponsors and their affiliates) may be the most likely option.

Conclusion

Tax-exempt and foreign investors in a securities partnership share a common interest in having the partnership avoid service income, but their interests diverge in other respects. If a significant portion of the partnership's financing is expected to come from foreign investors, forming an offshore parallel partnership for those investors continues to be the most desirable approach to address their specific concerns.

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[105] See note 82 *supra*.

S Corporations

Richard B. Comiter and Stephen R. Looney*

Minimizing the Built-in Gains Tax Imposed Under Section 1374

Recent changes in the tax law have caused an increasing number of C corporations to convert, or consider converting, to S corporation status.[1] Although a corporation that has converted from C corporation to S corporation status may enjoy considerable tax benefits attributable to its new status, the conversion process is fraught with potential pitfalls.[2] One of these is the built-in gains tax imposed under Section 1374 as revised by TRA '86[3] and by TAMRA.[4] This column examines the application and scope of the built-in gains tax and focuses on a number of planning techniques that may be used at both the preconversion and postconversion stages to minimize or eliminate the built-in gains tax.

Built-in Gains Tax

☐ **Imposition and Computation.** Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations.[5] Section 1374 applies to the built-in gains recognized by a corporation during the ten-year period following such corporation's conversion to S status.[6]

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* Richard B. Comiter, of the Florida Bar, is a partner with the law firm August & Comiter, P.A., in West Palm Beach, Florida. Stephen R. Looney is an associate with the Orlando, Florida, law firm Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth. He is also a member of the ABA Tax Section's S Corporation Committee.

[1] These recent changes include the repeal of the *General Utilities* doctrine, the reduction of individual tax rates below corporate tax rates, and the broadening of the scope of the corporate alternative minimum tax, which does not apply to S corporations.

[2] For an excellent discussion of the tax issues involved in converting from C corporation to S corporation status, see August, "Converting from a C to an S Corporation," 47 N.Y.U. Tax Inst. 14-1 (1989); L. Bravenec, *Federal Taxation of S Corporations and Shareholders* 6-1 (Practising Law Institute 2d ed. 1988).

[3] TRA '86, Pub. L. No. 99-514, 100 Stat. 2085, § 632 (1986).

[4] TAMRA, Pub. L. No. 100-647, 102 Stat. 3342, § 1006(f) (1988).

[5] I.R.C. § 1374(a). The purpose behind the enactment of the built-in gains tax by TRA '86 was to prevent the circumvention of the repeal of the *General Utilities* doctrine by electing to be an S corporation. Under § 1374(c)(1), only S corporations that were previously C corporations are subject to the built-in gains tax. Additionally, however, § 1374(d)(8) subjects S corporations with no prior C history to the built-in gains tax with respect to assets acquired from C corporations in certain tax-free asset acquisitions. See text accompanying notes 16, 17 *infra*.

[6] I.R.C. § 1374(d)(7). In the case of an S corporation's acquisition of assets subject to the built-in gains tax under § 1374(d)(8), the ten-year recognition period will begin on the day such assets

The amount of the built-in gains tax is presently 34 percent (the highest rate of tax set forth in Section 11(b)) of the "net recognized built-in gain" of the S corporation for its taxable year.[7]

The net recognized built-in gain of an S corporation is the lesser of the amount that would be the taxable income of the S corporation for the taxable year if only recognized built-in gains and recognized built-in losses were taken into account or such corporation's taxable income for the taxable year computed without the benefit of the dividends-received deduction or the deduction for net operating loss carryovers.[8] The term "recognized built-in gain" is defined as meaning any gain recognized during the ten-year recognition period, beginning on the effective date of the corporation's S election, from the disposition of any asset except to the extent that the S corporation can establish that the particular asset disposed of was not held by such corporation as of the effective date of its S election or that such asset's built-in gain (the excess of the asset's fair market value over its adjusted tax basis) as of the effective date of such corporation's S election was less than the gain recognized by the corporation on the disposition.

Similarly, the term "recognized built-in loss" is defined as meaning any loss recognized during the ten-year recognition period on the disposition of any asset to the extent that the S corporation can show that such asset was held by it as of the effective date of its conversion to S corporation status and that the amount of the loss recognized does not exceed the amount of such asset's built-in loss (the excess of the asset's adjusted tax basis over its fair market value) as of the effective date of the corporation's S election.[9]

As previously stated, the base of the built-in gains tax is the lesser of the amount that would be the taxable income of the S corporation for the taxable year if only its recognized built-in gains and recognized built-in losses were taken into account or such corporation's taxable income for the taxable year. Further reduction to the base of the tax is permitted for any net operating loss carryforwards and any capital loss carryforwards arising in a taxable year during which the corporation was a C corporation.[10] Additionally, the tax computed under Section 1374 may be reduced by business and alternative minimum tax credit carryforwards arising from years in which the corporation was a C corporation.[11]

☐ **Limitations on Built-in Gains Tax.** Section 1374(c)(2) provides that the amount of net recognized built-in gain taken into account under Section 1374 for any taxable year may not exceed the net unrealized built-in gain of all the corporation's assets less the net built-in gains recognized by the corporation in preceding years within the recognition period. Net unrealized built-in gain is the amount by which the fair market value of all the corporation's assets as of the beginning of its first taxable year as an S corporation exceeds the aggregate adjusted bases of such assets at such time.[12] The maximum amount of built-in gains subject to tax under Section 1374 is therefore limited to the amount of pre-C to S conversion appreciation in the corporation's assets and does not include any postconversion appreciation in such assets.

In addition to the limitation placed on the aggregate amount of net built-in gains that may be recognized by an S corporation, the taxable income limitation limits the amount of net built-in gains recognized by an S corporation on an annual basis. Because a corporation's taxable income may serve as the base for the built-in gains tax,[13] the maximum amount of net built-in gains (built-in gains less built-in losses) that must be recognized by an S corporation in a particular taxable year within the recognition period is limited to the amount of the corporation's taxable income for such year. The taxable income limitation was recently modified by TAMRA and requires the carryover of the excess of the corporation's net recognized built-in gains over its taxable income.[14] In other

are acquired from the C corporation rather than on the first day of the corporation's first taxable year as an S corporation. For the potential application of § 1374 outside of the ten-year recognition period, see note 40 *infra*.

[7] I.R.C. § 1374(b)(1). § 1374(b)(4) provides that where the gain is attributable to the disposition of an asset that would produce long-term capital gain, the rate of tax may not exceed the rate that would be imposed under § 1201(a). For corporations subject to the built-in gains tax, § 1366(f)(2) provides for the reduction of the amount of gain which would otherwise pass through to the corporation's shareholders by the amount of the built-in gains tax.

[8] I.R.C. § 1374(d)(2).

[9] I.R.C. §§ 1374(d)(3), 1374(d)(4).

[10] I.R.C. § 1374(b)(2). The use of net operating loss carryovers to offset the base of the built-in gains tax will presumably be subject to the limitations prescribed in § 382 and the use of capital loss carryovers to offset the base of the built-in gains tax will presumably be subject to the limitations prescribed in §§ 1211 and 1212. See, however, note 36 *infra* and accompanying text.

[11] I.R.C. § 1374(b)(3)(B), *as modified by* the Revenue Reconciliation Act of 1989 (RRA '89).

[12] I.R.C. § 1374(d)(1). If the aggregate adjusted bases of a corporation's assets exceed the aggregate fair market value of such assets as of the date of the corporation's conversion to S corporation status, the built-in gains tax will not apply to such corporation. § 1374(d)(5)(C) provides that a corporation's net unrealized built-in gain is to be properly adjusted for built-in income items (such as accounts receivable of cash basis taxpayers) and built-in deduction items (such as accounts payable of cash-basis taxpayers). RRA '89 clarified that items of income and loss that would be treated as built-in gain or built-in loss items if recognized within the recognition period are included in the computation of net unrealized built-in gain or net unrealized built-in loss, as of the first day of the corporation's first taxable year as an S corporation, without regard to when or whether such items are actually recognized within the recognition period.

[13] I.R.C. § 1374(d)(2)(A)(ii).

[14] I.R.C. § 1374(d)(2)(B), *as enacted by* TAMRA § 1006(f).

words, any recognized built-in gain which is not subject to the built-in gains tax because of the taxable income limitation must be carried forward and is subject to the built-in gains tax in the S corporation's succeeding taxable years to the extent that the S corporation subsequently has other taxable income (that is not already otherwise subject to the built-in gains tax) for any taxable year within the ten-year recognition period.

Nevertheless, the TAMRA modification providing for the carryover of any recognized built-in gain not taken into account because of the taxable income limitation is applicable only in the case of S elections filed on or after March 31, 1988. Consequently, corporations electing S corporation status by filing elections before March 31, 1988, and which are otherwise subject to the built-in gains tax, may utilize the taxable income limitation without regard to the new carryover provisions enacted by TAMRA.

☐ **After-Acquired Assets.** In addition to modifying the taxable income limitation on the built-in gains tax, TAMRA also clarified the treatment of after-acquired assets. Under Section 1374 as retroactively amended by TAMRA, where an asset having a built-in gain or loss held on the first day of S corporation status is exchanged for another asset in a transaction in which the new asset's basis is determined in whole or in part by reference to the basis of the old asset (such as in a like-kind exchange under Section 1031), the new asset will be treated as being held on the first day of S corporation status and as having the same built-in gain or loss as did the old asset.[15] The new asset will therefore be subject to the built-in gains tax to the same extent as the old asset.

In addition, TAMRA revised Section 1374 to expressly provide that the built-in gains tax applies to any asset acquired by an S corporation from a C corporation where the basis of such acquired asset in the hands of the S corporation is determined (in whole or in part) by reference to the basis of such asset in the hands of the C corporation (such as in a tax-free reorganization under Section 361).[16] Consequently, every asset acquisition from a C corporation will be subject to a separate determination as to the amount of net unrealized built-in gain and net recognized built-in gain, as well as to a separate ten-year recognition period beginning with the date the S corporation acquires such assets from the C corporation.[17] This rule

[15] I.R.C. § 1374(d)(6), *as enacted by* TAMRA § 1006(f).

[16] I.R.C. § 1374(d)(8), *as enacted by* TAMRA § 1006(f). Presumably, the built-in gains tax will also apply to tax-free acquisitions of assets from S corporations subject to the built-in gains tax. See Announcement 86-128, 1986-5 I.R.B. 5. Additionally, § 1374(d)(8) should apply only to S corporations (not already subject to the built-in gains tax) that acquire assets in tax-free transactions occurring *after* the effective date of TRA '86.

[17] In the case of multiple asset acquisitions subject to § 1374(d)(8), the

applies to all S corporations, regardless of when their S elections were made or whether such corporations have always been S corporations.

☐ **Dispositions.** An S corporation's recognized built-in gain includes gain recognized from the "disposition" of any asset. TAMRA clarified that the term "disposition" includes not only sales and exchanges, but other income recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income.[18] For example, the term "disposition" for purposes of the built-in gains tax includes the collection of accounts receivable by cash basis taxpayers and the completion of long-term contracts performed by taxpayers using the completed contract method of accounting. The Revenue Reconciliation Act of 1989 (RRA '89) amended Section 460 and no longer permits the use of the completed contract method of accounting for any portion of long-term contract income except under certain limited circumstances. The receipt of payments constituting principal with respect to qualifying installment obligations under Section 453 should presumably be treated as dispositions subject to the built-in gains tax imposed under Section 1374.[19]

A corporation utilizing the LIFO inventory method will be subject to the built-in gains tax with respect to dispositions of its inventory only to the extent that a LIFO inventory layer existing prior to the beginning of such corporation's first S year is subsequently invaded.[20] The impact of the built-in gains tax on the disposition of inventory (regardless of which inventory method is used by the corporation) depends, in large part, on the manner in which the fair market value of inventory is determined for purposes of the built-in gains tax.[21]

recordkeeping attendant to the segregation of the net unrealized built-in gain and recognized built-in gain and loss for each such acquisition could become burdensome. Presumably, the disposition of an asset having built-in loss from one acquisition could not be used to offset a built-in gain generated by the disposition of an asset acquired in a different transaction. It is also unclear how the taxable income limitation will be applied in such cases. For example, should the assets acquired by an S corporation (already subject to the built-in gains tax on its own assets) from a C corporation in a transaction covered by § 1374(d)(8) be subject to their own taxable income limitation, or should there be only one taxable income limitation? If so, how should a single taxable income limitation be apportioned among the different assets of the S corporation that are subject to separate built-in gains tax computations? See Orbach & Raymond, "Questions About BIGs and BILs for S Corporations," 43 Tax Notes 1275 (June 5, 1989).

[18] I.R.C. § 1374(d)(5).

[19] See August, note 2 *supra*, at 14-55.

[20] See note 45 *infra* and accompanying text.

[21] Neither the statute nor the legislative history of TRA '86 provides guidance as to how the fair market value of inventory is to be determined. If, for example, the retail value of inventory is

Preconversion Planning Opportunities

The following discussion focuses on methods by which the built-in gains tax may be either minimized or eliminated for those corporations that are planning to convert from C corporation to S corporation status.

☐ **Early Election.** Once a corporation has made the decision to convert from C corporation to S corporation status, it should make its S election as soon as possible, since only preconversion asset appreciation, and not postconversion asset appreciation, is subject to the built-in gains tax. Additionally, the sooner the election is made, the sooner the ten-year recognition period during which the built-in gains tax is in effect will lapse.

An early election is crucial not only for an existing C corporation converting to S corporation status but also for a sole proprietorship, partnership, or other unincorporated business which is incorporating. In such cases, it is crucial that the unincorporated business file its S election effective for its first taxable year so that it can completely escape application of the built-in gains tax (except with respect to any assets that it may subsequently acquire from C corporations). If the newly formed corporation fails to elect S corporation status for its first taxable year and later converts to S corporation status, such corporation will be fully subject to the built-in gains tax because of its C corporation history, even if it was a C corporation for only one taxable year. The failure of an unincorporated business to elect S corporation status for its first taxable year as a corporation is particularly detrimental because not only will preconversion *corporate* appreciation in its assets be subject to the built-in gains tax but also any *preincorporation* appreciation in its assets will be subject to the built-in gains tax.[22]

☐ **Deferral of Disposition of Loss Assets.** Where a C corporation contemplating conversion to S corporation status has built-in loss assets that it intends to dispose of in the near future, the corporation should defer the disposition of such built-in loss assets until after it has converted to S corporation status in order to minimize the impact of the built-in gains tax. If such built-in loss assets are not disposed of prior to conversion to S corporation status, the built-in losses in these assets will reduce the overall net unrealized built-in gain limitation on the built-in gains tax and will also (when disposed of by the corporation) offset recognized built-in gains and reduce the corporation's taxable income. Since built-in deduction items (such as accounts payable of a cash basis corporation) are treated as built-in losses for the taxable year in which such amounts are deducted by the corporation,[23] a C corporation contemplating conversion to S corporation status should also defer the deduction of such items until after that conversion.

☐ **Preconversion Transfer of Loss Assets to Corporation.** Another preconversion technique which may be utilized in limited circumstances to reduce the effect of the built-in gains tax involves the preconversion transfer, under Section 351 or Section 118, of built-in loss assets to the converting corporation. This particular method of minimizing the built-in gains tax must be used with caution, however, since the Service has announced that it will implement rules that will provide that built-in loss property contributed to a corporation after the date that is two years before the earlier of the beginning of the corporation's first taxable year as an S corporation or the date the S election was filed by such corporation, will *not* be taken into account in computing the corporation's overall net unrealized built-in gain limitation.[24] Presumably, when the corporation disposes of such assets, the loss recognized by the corporation on such disposition will not be taken into account in determining the net recognized built-in gains or net recognized built-in losses of the corporation.[25] However, a corporation may receive the benefit of built-in loss assets contributed to it prior to its conversion to S corporation status if the corporation can demonstrate a "clear and substantial relationship" between the contributed property and the corporation's business.[26]

☐ **Accounts Receivable Planning Opportunities.** Special tax plan-

used, the built-in gains tax attributable to the disposition of inventory could be significant. If, on the other hand, the wholesale value of inventory is used, the disposition of inventory will be subject to little, if any, built-in gains tax. The Service has discussed the possibility of applying the principles contained in § 1060 (allocation of purchase price in asset sales) to determine the value allocated to inventory for built-in gains tax purposes. If this approach were utilized, it is doubtful that inventory would be allocated more than its wholesale value, and thus, the impact of the built-in gains tax on the disposition of inventory would be minimal. See Partnership Tax Rep. (CCH), at 7 (Aug. 29, 1988).

[22] Preincorporation appreciation will be subject to the built-in gains tax since a corporation, in a § 351 incorporation transaction or in a § 118 capital contribution transaction, will receive only a carryover basis in the assets transferred to it in such transaction. I.R.C. § 362(a).

[23] I.R.C. § 1374(d)(5)(B) *as modified by* RRA '89. RRA '89 clarified that a net operating loss or capital loss carryforward is not treated as a separate item of built-in deduction but simply offsets recognized built-in gain to the extent otherwise permitted.

[24] Announcement 86-128, 1986-5 I.R.B. 5.

[25] See Orbach & Raymond, note 17 *supra*, at 1277. It is unclear whether the disposition of such built-in loss assets may be used to decrease the taxable income of the S corporation in determining its taxable income for purposes of limiting the amount of net recognized built-in gain taken into account during the taxable year.

[26] Announcement 86-128, 1986-5 I.R.B. 5.

ning opportunities are available to minimize the built-in gains tax in the case of cash basis corporations. As discussed previously, the collection of accounts receivable by a cash basis S corporation triggers application of the built-in gains tax. Because of the pass-through nature of an S corporation, the collection of accounts receivable by a cash basis corporation that has converted from C corporation to S corporation status will result in a forced double taxation on such receivables, yielding an approximate effective tax rate of 52.4 percent under current tax rates.[27] If, however, a corporation accelerates its receivables income and recognizes such income prior to its conversion to S corporation status, the corporation may be able to defer (possibly indefinitely) shareholder-level tax on such receivables income until distribution of the earnings and profits generated by the collection of those receivables to the corporation's shareholders. Additionally, the recognition of receivables income by a corporation prior to its conversion to S corporation status will have the added benefit of decreasing its overall net unrealized built-in gain limitation.[28] A cash-basis corporation converting from C corporation status to S corporation status might also consider changing from the cash basis of accounting to the accrual basis prior to its conversion if it is unable to otherwise accelerate recognition of income on its accounts receivable.[29]

[27] For example, assume that a cash basis C corporation has $10,000 of accounts receivable. If the C corporation accelerates the recognition of these receivables in its last C year, assuming a maximum 34 percent corporate tax rate, the tax imposed on the collection of the receivables will be $3,400. Additionally, the earnings and profits of the corporation will be increased by $6,600 ($10,000 income less $3,400 tax). The shareholders will not be taxed on these earnings and profits, however, until the earnings and profits are distributed by the corporation to the shareholders. On the other hand, if the receivables are collected in the corporation's first S year, the built-in gains tax will apply, and the shareholders will also be taxed on the pass-through of income net of tax. Assuming a 34 percent corporate tax rate and a 28 percent individual tax rate, the corporate-level built-in gains tax will be $3,400 and the shareholders' tax will be $1,848, yielding an approximate effective tax rate of 52.4 percent. See Bravenec, note 2 *supra,* at 6-52, 6-53.

[28] The preconversion recognition of receivables income will, however, have the negative effect of increasing the earnings and profits of the C corporation. The increased earnings and profits will, in turn, affect the distribution rules applicable to the corporation after its conversion to S corporation status under § 1368(c) and could also result in the imposition of a corporate-level tax on the corporation under § 1375 and in the termination of the corporation's S election under § 1362(d).

[29] Although still uncertain, it would appear that any net positive adjustment caused by the change from the cash basis of accounting to the accrual basis of accounting will not be treated as a built-in gain for purposes of the built-in gains tax. See Bravenec, note 2 *supra,* at 6-54. Prior to converting from the cash method of accounting to the accrual method, a corporation should consider the benefits of the cash method over the accrual method, including the ability to control more easily the timing of income and deductions.

☐ **Inventory Planning Opportunities.** A corporation that costs its inventory under the FIFO method of accounting will generally be subject to the built-in gains tax on the disposition of its inventory on hand as of the effective date of the conversion. Thus, prior to a conversion to S status, a C corporation should consider converting to the LIFO inventory method, because a corporation that uses the LIFO inventory method will be subject to the built-in gains tax on the disposition of its inventory only if it invades a LIFO inventory layer that existed prior to its S election. Before a corporation changes its inventory costing method from the FIFO method to the LIFO method, however, it should consider the impact of Section 1363(d), as enacted by RA '87. This section requires a converting corporation (which inventories goods under the LIFO inventory method) to recapture in income the amount by which the value of its inventory under the FIFO method exceeds the value of its inventory under the LIFO method.[30] Moreover, the adverse tax consequences caused by this LIFO recapture rule might motivate a corporation to change from the LIFO method to the FIFO method prior to its conversion to S status.[31]

[30] Any increase in tax caused by the LIFO recapture amount is payable in four equal installments; the first installment is due by the due date (without regard to extensions) of the corporate tax return for the corporation's last year as a C corporation. The three succeeding installments are due and payable by the due date (without regard to extensions) of the corporation's tax return for the three succeeding taxable years. No interest is payable on these installments if they are paid by their respective due dates. The LIFO recapture rule is generally effective for S corporation elections made after December 17, 1987. See RA '87, Pub. L. No. 100-203, 101 Stat. 1330, § 10,227(a).

[31] By changing from the LIFO inventory method to the FIFO inventory method prior to converting to S corporation status, postconversion dispositions of inventory owned by the corporation as of the date of the conversion will be subject to the built-in gains tax. Announcement 86-128, 1986-5 I.R.B. 5. Additionally, in Rev. Proc. 88-15, 1988-1 C.B. 683, the Service provided that a corporation changing from LIFO to FIFO prior to electing S corporation status could not take advantage of the six-year § 481(a) adjustment period to recognize the income generated by the change from LIFO to FIFO. Rather, the Service applied rules similar to those contained in § 1363(d) (LIFO recapture) and required the corporation to pay the increase in its tax caused by its preconversion change from LIFO to FIFO in four equal installments. The first installment was due by the due date of the corporation's tax return for its last year as a C corporation, and the remaining installments were due and payable by the due date of the corporation's tax return for the three succeeding years. A corporation contemplating a preconversion change from LIFO to FIFO should also consider the advantage LIFO has over FIFO during times of rising prices (i.e., LIFO produces a lower ending inventory figure than does FIFO, thus increasing cost of goods

☐ **Appraisal of Assets.** Where a converting corporation can establish either that the particular asset disposed of was not held by the corporation as of the effective date of its conversion from C corporation to S corporation status or that such asset's built-in gain as of the date of the corporation's conversion from C to S status was less than the gain recognized by the corporation on such disposition, the amount of the corporation's recognized built-in gain will be reduced accordingly.[32] The built-in gains tax is thus limited to the amount of the converting corporation's preconversion appreciation in its assets. Therefore, it may be essential for the converting corporation to have each of its assets identified and appraised as of the effective date of its conversion.

Postconversion Planning Opportunities

In addition to the preconversion planning opportunities previously discussed, there are a variety of techniques that may be used by the converting corporation to minimize or eliminate its built-in gains tax following its conversion from C corporation to S corporation status.

☐ **Preservation of Elections.** Because the excess capital gains tax imposed by Section 1374 prior to its amendment by TRA '86 is generally less burdensome than the new built-in gains tax imposed under amended Section 1374, in most cases it will be beneficial for those C corporations that filed S corporation elections prior to 1987 to retain and preserve such elections so as not to become subject to the new built-in gains tax.[33] Similarly, since the rules applicable to C corporations that converted to S corporation status during the transitional period and that otherwise qualified for transitional rule relief are less burdensome than the rules imposed under the new built-in gains tax, corporations that made transitional-period S elections should retain and preserve such elections so as not to become subject to the new built-in gains tax.[34]

Though corporations filing S elections after 1988 are fully subject to the new built-in gains tax, it will still be beneficial for these corporations to preserve such elections to avoid the application of a new ten-year recognition period, which would result if such corporation's S election terminates and the corporation subsequently files a new S election.

☐ **Matching of Built-in Losses With Built-in Gains.** A corporation may minimize the impact of the built-in gains tax by disposing of assets that have built-in losses during taxable years in which it has disposed of assets having built-in gains. Similarly, a cash basis corporation subject to the built-in gains tax should match built-in loss items (such as accounts payable) with built-in gain items (such as accounts receivable) recognized during the taxable year. Corporations electing S status after March 31, 1988, must carry forward any excess recognized built-in gains over built-in losses that are not subject to the built-in gains tax due to the taxable income limitation. Thus, it will be even more important for such corporations (as opposed to corporations making S elections prior to March 31, 1988, which are not subject to the carryforward rule) to reduce their recognized built-in gains by recognized built-in losses in the same year so as to reduce the net recognized gains to an amount less than the taxable income of the corporation for the taxable year. In other words, if a corporation that filed its S election after March 31, 1988, can make the base of the built-in gains tax the excess of recognized built-in gains over recognized built-in losses rather than taxable income, that corporation will be able to avoid application of the new carryforward rule enacted by TAMRA.

☐ **Reduction of Taxable Income.** Since the base of the built-in gains tax is the lesser of the taxable income of the corporation or the amount that would be its taxable income if only recognized built-in gains and recognized built-in losses were taken into account, the corporation may minimize or eliminate the imposition of the built-in gains tax for a given taxable year by reducing or eliminating its tax-

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sold (over cost of goods sold under FIFO) and decreasing taxable income (below taxable income under FIFO)).

[32] I.R.C. §§ 1374(d)(3)(A), 1374(d)(3)(B).

[33] § 1374, prior to its amendment by TRA '86 (Old § 1374), imposed a tax on the "excess capital gains" of S corporations that were formerly C corporations for the three-taxable-year period beginning with the first day of the corporation's first taxable year as an S corporation. Old § 1374(a) subjected S corporations to a corporate-level tax if (1) the net capital gain (the excess of long-term capital gains over capital losses) of the S corporation for the taxable year exceeded $25,000; (2) the S corporation's net capital gain for the taxable year exceeded 50 percent of its taxable income for such taxable year; and (3) the S corporation's taxable income for the taxable year exceeded $25,000. Old § 1374(b) specified that the amount of the excess capital gains tax was the lower of (1) an amount equal to the tax, determined under § 1201(a), on the amount by which the net capital gain of the S corporation for the year exceeded $25,000; or (2) an amount equal to the tax that would be imposed by § 11 on the taxable income of the S corporation for the year if the corporation were not an S corporation.

[34] Transitional rule relief was available to certain "qualified corporations" (as defined under TRA '86 § 633(d)(5)) which filed S corporation elections prior to 1989. For such corporations, the new built-in gains tax applies only to ordinary and short-term capital gain assets, and the old excess capital gains tax applies to long-term capital gain assets, provided the value of the qualified corporation was less than $5 million. Where a qualified corporation's value exceeded $5 million (but did not exceed $10 million), both the new built-in gains tax and the old excess capital gains tax applied to a portion of the corporation's long-term capital gains assets. Corporations having a value of more than $10 million did not qualify for the special transitional rule relief. See Rev. Rul. 86-141, 1986-2 C.B. 151.

able income. However, as previously discussed, for corporations making S elections after March 31, 1988, to the extent that the taxable income of the corporation is less than the excess of the corporation's recognized built-in gains over its recognized built-in losses, such excess will be carried forward and treated as built-in gain in the corporation's succeeding taxable year. Nevertheless, if the corporation can eliminate (or greatly minimize) its taxable income during the entire ten-year recognition period (by means of the payment of compensation to its shareholders or by some other method), the corporation may be able to completely avoid imposition of the built-in gains tax.[35] For corporations that made S elections prior to March 31, 1988, the reduction of taxable income is just as important as the matching of recognized built-in losses with recognized built-in gains since such corporations are not subject to the carryforward rule enacted by TAMRA.

☐ **Net Operating Loss Carryforwards.** Under Section 1374(b)(2), the base of the built-in gains tax for a particular taxable year, whether it is the excess of recognized built-in gains over recognized built-in losses or the corporation's taxable income, may be reduced by net operating loss carryforwards arising from years in which the corporation was a C corporation. Likewise, capital loss carryforwards from C years are allowed to reduce the base of the built-in gains tax. Where an ownership change occurs in conjunction with a conversion from C corporation to S corporation status, there is some support for the proposition that the net operating loss limitations contained in Section 382 should *not* apply to limit the amount of net operating loss carryforward which may be used to reduce the built-in gains tax base.[36] This remains an unresolved

[35] Although the Service has not traditionally asserted "reasonable compensation" arguments with respect to S corporations, the reduction of an S corporation's taxable income for purposes of minimizing the built-in gains tax by means of the payment of compensation could prompt the Service to utilize reasonable compensation arguments to attack such schemes. See Andrews, "Current Non-Stock Executive Compensation and Fringe Benefit Issues," S Corporations: J. Tax, Legal and Bus. Strategies 3 (1989).

[36] The argument that § 382 should *not* apply to limit the amount of net recognized built-in gain which may be offset by net operating loss carryforwards is founded on the technical language of §§ 382 and 1374. While § 382 places a limitation on the amount of *taxable income* for any postchange year which may be offset by prechange losses (I.R.C. § 382(a)), the built-in gains tax is imposed on the *net recognized built-in gain* of the S corporation as defined in § 1374 and not on the S corporation's *taxable income*. Though the base of the built-in gains tax may be the taxable income of the corporation (without taking into account net operating loss carryforwards), this does not make "net recognized built-in gain" the equivalent of "taxable income" for § 382 purposes. However, § 1374(b) does provide that for purposes of determining the amount of any net operating loss which may be carried forward to subsequent taxable years, the amount of the net recognized built-in gain is to be treated as taxable income. Therefore, it is probable that the Service will take the position that for purposes of § 382, net recognized built-in gain should be treated as taxable income.

issue, however, and it is doubtful that the Service would follow this position. The tax computed under Section 1374 may also be reduced by business and alternative minimum tax credit carryforwards from C years.[37]

☐ **Deferral Techniques.** Another postconversion method of minimizing the impact of the built-in gains tax is for the S corporation to dispose of its built-in gain assets in nonrecognition transactions (e.g., in a Section 1031 like-kind exchange, a Section 1033 involuntary conversion, a Section 351 incorporation transaction, or a Section 361 reorganization transaction) so as to defer recognition of the built-in gain inherent in its assets. Though the amendments made by TAMRA subject any asset received by an S corporation in a nonrecognition transaction (such as those previously mentioned) to the built-in gains tax to the same extent as the asset that was disposed of,[38] the nonrecognition transaction itself will not trigger application of the built-in gains tax and may therefore be used as a deferral device.

An S corporation may also minimize the impact of the built-in gains tax following its conversion to S status by use of the installment sales method under Section 453. Where the corporation must dispose of an asset having a built-in gain, it should structure the disposition as a deferred payment sale under Section 453 with a balloon payment due in the year following the end of the ten-year recognition period. Under this technique, application of the built-in gains tax may be completely avoided.[39] However, the Service has indicated that it may not allow the built-in gains tax to be circumvented in this fashion.[40]

Where appropriate economic circumstances exist, consideration should be given to the use of a ten-year lease with an option to buy at the end of the lease term as a deferral technique to avoid the imposition of the built-in gains tax during the ten-year recognition period. If, however, a transaction is structured as a lease but is, in substance, a sale, it may be recharacterized for tax purposes,[41] which, in turn, could trigger the application of the built-in gains tax.[42] The best

[37] I.R.C. § 1374(b)(3)(B) *as modified by* RRA '89.

[38] I.R.C. § 1374(d)(6).

[39] See Rev. Rul. 78-89, 1978-1 C.B. 272; LTR 8829046; LTR 8704042; LTR 8649032; LTR 8243169.

[40] See Notice 90-27, 1990-15 I.R.B. 1, where the Service stated that it will issue regulations providing that under certain circumstances § 1374 will continue to apply to income recognized under the installment method during taxable years ending *after* the expiration of the ten-year recognition period.

[41] See Swift Dodge v. Comm'r, 692 F.2d 651 (9th Cir. 1982).

[42] See notes 39, 40 *supra* and accompanying text for a discussion of the

approach to counter an argument from the Service that a lease is a disguised installment sale is for the lease payments to be based on a fair market value rent coupled with an option to purchase for fair market value at the end of the lease term.[43] Nevertheless, if the economics of the transaction require a purchase option that does not necessarily reflect the fair market value of the asset at the end of the lease term, there is case law that may under certain circumstances support the characterization of such a transaction as a lease rather than a sale.[44]

In addition to the deferral techniques involving nonrecognition transactions, installment sales, and long-term leases, a corporation should consider simply avoiding the disposition of assets having built-in gain during the ten-year recognition period. Alternatively, where such dispositions are unavoidable, disposition of assets having built-in losses should be matched with the disposition of built-in gain assets, as discussed previously, to minimize the corporation's built-in gains tax exposure.

use of installment sales as a method to minimize or avoid the built-in gains tax.

[43] The fair market value of the leased asset at the end of the lease term could be based on an appraiser's best estimate of its fair market value at the time of execution of the lease or an appraisal prepared at the end of the lease term.

[44] Where the lease contains an option to purchase, its mere presence does not require the transaction to be recharacterized, if equity is not created. See Lockhart Leasing Co. v. Comm'r, 54 T.C. 301 (1970), *aff'd,* 446 F.2d 269 (10th Cir. 1971). A lessee tends to acquire equity when the sum of the rental payments plus option price equals or exceeds the fair market value of the property. See Estate of Starr v. Comm'r, 274 F.2d 294 (9th Cir. 1959).

☐ **Inventory Planning Opportunities.** If the converting corporation valued its inventory under the LIFO inventory method prior to its conversion to S corporation status, it is crucial, in order to avoid application of the built-in gains tax to inventory dispositions, that the corporation not invade a LIFO inventory layer that existed prior to the corporation's conversion to S corporation status.[45] If the converting corporation is successful in avoiding the invasion of a preexisting LIFO inventory layer, the corporation will completely avoid imposition of the built-in gains tax on the disposition of its inventory.[46]

[45] If a corporation has been utilizing the FIFO inventory method prior to its conversion to S corporation status, it might consider converting from FIFO to LIFO *after* its conversion to S corporation status to avoid the LIFO recapture rule imposed under § 1363(d) and at the same time avoid the built-in gains tax by maintaining preexisting inventory layers. Such a technique, however, would likely be challenged by the Service under its § 337(d) regulatory authority as a manipulation of accounting methods to avoid the built-in gains tax. See August, note 2 *supra,* at 14-50.

[46] Such corporation is, however, still subject to the LIFO inventory recapture rule of § 1363(d). See note 30 *supra* and accompanying text.

Conclusion

Though the built-in gains tax poses a significant obstacle to a corporation converting from C corporation to S corporation status, there exists a multitude of planning opportunities, both preconversion and postconversion, which the alert tax practitioner may use to either minimize or eliminate the converting corporation's exposure to the built-in gains tax.