

Internal Revenue Service

Department of the Treasury

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Date:

September 20, 2000

LEGEND:

Distributing =

Controlled =

Dear :

This ruling letter is in reply to a letter dated March 27, 2000, that requests that the Internal Revenue Service issue a number of rulings relating to the federal income tax consequences of a proposed transaction. Except for two requested rulings involving section 1363(d) of the Internal Revenue Code, the Service responded to this request by a ruling letter dated August 7, 2000. This ruling letter addresses the two remaining requests that involve section 1363(d).

This ruling letter is an addendum to the ruling letter of August 7, 2000. This ruling letter adopts and incorporates by reference the ruling letter dated August 7, 2000. Additional information was submitted in a letter dated September 6, 2000. This ruling letter is based in part on the additional information submitted in the letter of September 6, 2000.

Distributing, which has been taxed as an S corporation since its incorporation, intends to vertically divide its present business into two businesses by reorganizing within the meaning of section 368(a)(1)(D). To accomplish this reorganization, Distributing has formed a subsidiary, Controlled, which has elected to be taxed as an S corporation effective the date of its incorporation. Distributing will transfer some of its assets in exchange for all of Controlled's common stock. Included in these assets is inventory that Distributing has valued for federal income tax purposes under the last-in, first-out (LIFO) inventory method authorized by section 472. Controlled will assume all of the liabilities related to the transferred assets. Immediately after the transfer, Distributing will distribute all of Controlled's common stock to Distributing's sole shareholder.

The requested rulings involving section 1363(d) are as follows:

1. Controlled is not required to include in its gross income any LIFO recapture amount under section 1363(d) if Controlled timely elects to be an S corporation for its first taxable year, and otherwise meets the other requirements of section 1361(b).
2. Because Distributing is an S corporation, Distributing is not required to include in its gross income any LIFO recapture amount pursuant to section 1363(d).

Section 1363(d)(1) provides that if an S corporation was a C corporation for the last taxable year before the first taxable 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 taxable year, then the "LIFO recapture amount" must be included in the corporation's gross income for such last taxable year. Section 1363(d)(3) defines the term "LIFO recapture amount" as the amount by which a corporation's inventory under the first-in, first-out (FIFO) method authorized by section 471 exceeds its inventory under the LIFO method, measured as of the close of the corporation's last taxable year as a C corporation. Section 1.1363-2(a)(2) provides that a C corporation must include the LIFO recapture amount in its gross income in the year of transfer by the C corporation to an S corporation of LIFO inventory assets if: (1) the C corporation inventoried assets under the LIFO method during the taxable year of the transfer; and (2) the transfer was part of a nonrecognition transaction in which the transferred assets constituted transferred basis property.

Section 1363(d) applies only if a corporation was a C corporation for the last taxable year before becoming an S corporation. Distributing has always been an S corporation. Controlled has elected to be an S corporation beginning with its first taxable year. Thus, because neither corporation will be a C corporation for such last taxable year, section 1363(d) is not applicable to the proposed transaction. Similarly, section 1.1363-2(a)(2) applies only if a C corporation transfers LIFO inventory assets to an S corporation. Thus, because Distributing is not a C corporation, section 1.1363-2(a)(2) is not applicable to the proposed transaction.

Accordingly, a ruling is provided that Controlled is not required to include in its gross income any LIFO recapture amount under section 1363(d) because Controlled has elected to be an S corporation beginning with its first taxable year. In addition, a ruling is provided that Distributing is not required to include in its gross income any LIFO recapture amount under section 1363(d) because Distributing is an S corporation.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of

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the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling letter has no effect on the ruling letter issued to Distributing on August 7, 2000. A copy of this ruling letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

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.

This ruling is directed only to the taxpayer requesting 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 your authorized representative.

Sincerely,
Associate Chief Counsel
(Income Tax & Accounting)
By: Eric L. Pleet
Senior Technician Reviewer, Branch 7