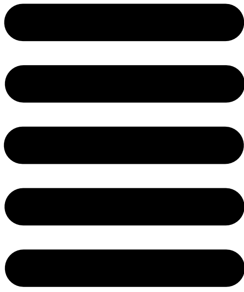

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Transformers: Beware Built-in Gains

By Robert W. Wood • Wood & Porter • San Francisco

Reminiscing about *General Utilities* repeal last month (*see* General Utilities *Redux*, M&A Tax Rep., Nov. 2009, at 7), got me thinking about Internal Revenue Code Section ("Code Sec.") 1374. Put another way, it got me thinking about built-in gains. "Built-in gains" is one of those eye-of-the-beholder phrases. To true Subchapter C tax lawyers, it probably invokes thought about net-operating losses, Code Secs. 382 and 384.

To others, it triggers worry about Code Sec.1374. That provision has been in the Internal Revenue Code for generations, but was radically revised with the repeal of the *General Utilities* doctrine in 1986. In its post-1986 incarnation, Code Sec. 1374 imposes a kind of Subchapter C tax regime on S corporations that are first C corporations.

Transformers

A C corporation morphing into an S corporation must typically endure a 10-year recognition period under Code Sec. 1374. Despite the passthrough character of S corporations, this means that a corporate-level tax is imposed on an S corporation's gain that arose prior to the conversion from C to S corporation status during the first 10 tax years that the S election is in effect. If you have your druthers, that is why an S corporation that was *always* an S corporation is infinitely better than an S corporation that was *previously* a C corporation. To my mind, that is what accounts for the now knee-jerk reaction many of us in practice have to make certain that we discuss S elections.

However, as part of the recently enacted American Recovery and Reinvestment Act of 2009 (P.L. 111-5), Congress has provided a windfall to certain S corporations that previously converted from C corporation status. Code Sec. 1374(d)(7)(B) now provides that for the tax years 2009

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and 2010, no corporate level tax will be imposed if the seventh tax year in the corporation's recognition period preceded such tax year.

So, former C corporations that converted to S corporations in 2001 or 2002 are in luck. Instead of having to wait until 2012 or 2013 to be free of the built-in gain tax taint, they can start selling appreciated assets this year or next without incurring double taxation. This Congressional largesse should not be taken lightly.

Despite the limitation imposed on converted C corporations, we do it early and often. You don't want to allow a corporation to operate as a C corporation before converting to S status if you can help it. Even one year as a C corporation can complicate your life materially, since it triggers the application of Code Sec. 1374.

It also accounts for the reason that many who are in the C to S conversion mode need to consider appraisals. Under Code Sec. 1374 only the appreciation that occurred during the C corporation years is subject to the built-in gain tax. Post–S election appreciation is taxed under the single tax S corporation regime. That means values and dates are important.

There have been a number of skirmishes about the operation of Code Sec. 1374, and various attempts have been made to get around it. Much of it comes down to valuation questions and how good the taxpayer's documents prove to be. Recently though, a private letter ruling addressed an interesting question about the scope of Code Sec. 1374 *vis-à-vis* partnership interests.

New Ruling

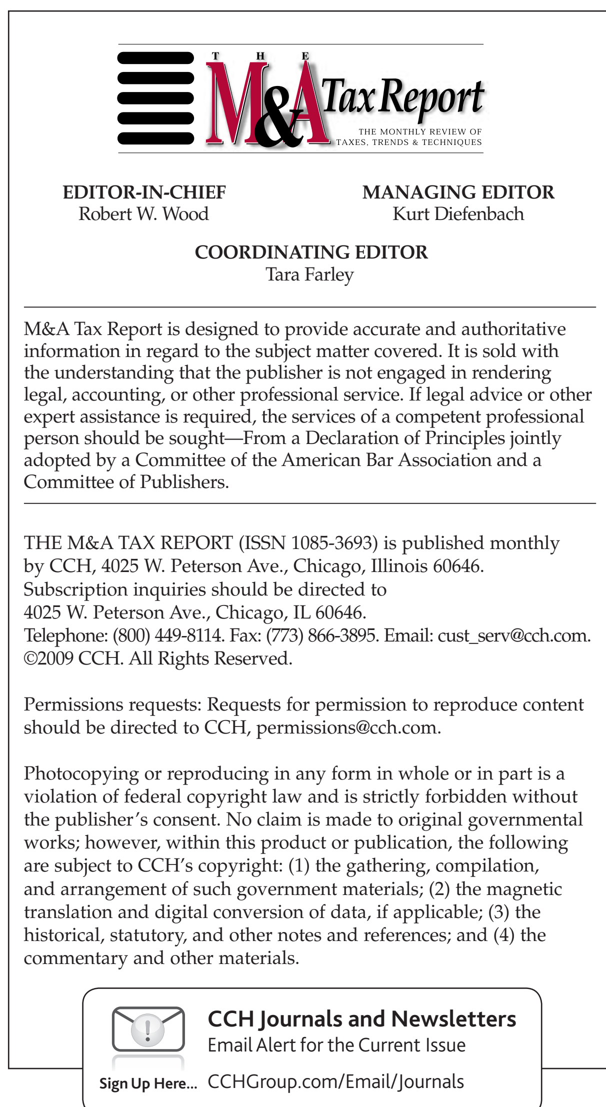
In LTR 200909001 (Nov. 18, 2008), the IRS asked whether Code Sec. 1374 applied to an S corporation's sale of partnership interests. If an S corporation holds a partnership interest for *more* than 10 years after the effectiveness of its S election and then sells it, is Code Sec. 1374 triggered? That may sound like a stupid question, since the gain recognition period of Code Sec. 1374 is only 10 years.

In fact, the IRS does conclude that partnership interests held more than 10 years are not a problem, escaping Code Sec. 1374's clutches. Yet LTR 200909001 also considers an S corporation that had elected S status, and that later received property from a liquidating C corporation.

The S corporation held some partnership units from its C corporation alter ego acquired more than 10 years previously. The S corporation bought additional partnership units for cash while it was an S corporation. Finally, as if this wasn't already complex, the S corporation received some partnership units from the partnership itself in exchange for property received upon the liquidation of a C corporation within the last 10 years.

Ten Years Plus?

The S conversion occurred more than 10 years in the past. That might suggest that Code Sec. 1374 simply should not apply. However, the IRS notes that each block of the units in the partnership had to be evaluated under the 10-year recognition period. Code Sec. 1374(d)(8) prescribes a 10-year recognition period for Code Sec. 332 liquidations that occurred within 10 years.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Code Sec. 1374(d)(6) restarts the 10-year holding period for all of the interests in a partnership, because partnerships have a unified basis for interests. That means each unit's basis would reflect the exchanged basis acquired within the last 10 years.

Let's look at Code Sec. 1374(d)(6), which details what happens to partnership interests. This subsection says that if the adjusted basis of an asset is determined (in whole or in part) by reference to the adjusted basis of any other asset held by the S corporation as of the beginning of the first tax year referenced in Code Sec. 1374(d)(3), the asset must be treated as held by the S corporation as of the beginning of the first such tax year (for which the S corporation qualified as an S corporation). As applied to partnerships, this makes perfect sense given their passthrough character.

More Fodder

A more classic example of situations in which S corporations that were previously C corporations have difficulty involves transfers from C corporations. In my experience, taxpayers and advisors are more equipped to spot that issue. It's quite clear that an S corporation that swallows up a small C corporation in a merger must worry about built-in gain exposure even though the S corporation may always have been an S corporation.

But as you evaluate built-in gain tax exposure, don't forget to monitor partnership interests as well.