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6.0 LIFO RECAPTURE TAX

6.1 LIFO RECAPTURE TAX - SUMMARY

The LIFO Recapture Rule was designed to prevent corporations from avoiding built-in gains from the sale of inventory.

A C-Corporation is subject to LIFO Recapture if it used the LIFO method for valuing its inventory for its last tax year before electing S-Corporation status.

The LIFO recapture amount is the difference (if any) by which the inventory valued under the FIFO method exceeds the inventory valued under the LIFO method. Inventory amounts are determined as of the close of the last C year, IRC §1363(d)(3). If the LIFO inventory amount exceeds the FIFO amount there is no LIFO recapture amount.

The “LIFO recapture amount” is included in the income of the last C-Corporation tax year, (IRC §1363(d)(1)), under other income and any resulting increase in tax is payable in four equal installments over four tax years. The first installment is payable with the final return as a C-Corporation (IRC §1363(d)(2)) and the remaining three payments are made with the S-Corporation Return.

If an S-Corporation files a final return before all installment payments are made, the unpaid installments are due with the final return.

Additionally, a C-Corporation holding LIFO inventory indirectly through a partnership must recognize a lookthrough LIFO recapture amount if it either elects to be an S-Corporation or transfers its partnership interest to an S-Corporation in a nonrecognition transaction.

6.2 LIFO TERMS AND DEFINITIONS

LIFO Layers -- Increment

For purposes of Specific Goods Method, an increment occurs when there is an increase in the unit quantity of an item in ending inventory over the quantity that existed in the opening inventory, applying the current-year amounts. (See Example A at S Corp Chapter 6.4)

For purposes of Dollar-Value Method, an increment occurs when the ending inventory at base-year amounts exceeds the beginning inventory at base-year amounts. If there is an increment under the Dollar-Value Method, an index must be computed to relate current-year cost to base-year cost. (See S Corp Chapter 6.3.2)

Invasion of LIFO Layers -- Decrement / Liquidation

A layer is invaded only when the ending inventory is less than the beginning inventory. When the inventory is decreased, the most recently added inventory layer has the first layer removed. Similar to 2-1, current-year amounts are used for Specific Goods Method, while base-year amounts are used for Dollar-Value Method.

LIFO Inventory Valuation

The valuation of LIFO inventory is the sum of all LIFO layers since the LIFO inventory method was adopted.

Base Year

The year that the taxpayer adopts LIFO.

Base-Year Amounts

The cost of inventory based on the base-year cost.

Current-Year Amounts

The cost of inventory based on current-year cost. Current-year cost can be determined by one of four options; latest acquisition cost during the year, earliest acquisition cost during the year, average acquisition costs during the year, or any other proper method that clearly reflects income.

6.3 LIFO INVENTORY METHODS

Studies have disclosed that the majority of taxpayers utilizing the LIFO method of inventory valuation use the dollar-value method or dollar-value retail method instead of inventory methods based on physical quantities. Following are brief descriptions of accepted LIFO methods.

6.3.1 LIFO Inventory Methods Based Physical Quantities

Single Goods / Unit LIFO - Each good sold is matched with each good in inventory. This method is most practical in situations where relatively few inventory items are handled such as jewelry, automobiles, furniture, special order manufacturing, etc., but is impractical in businesses that have numerous goods in inventory. (Chapter Example A at S Corp 6.4).

LIFO Pools - Goods are combined into natural groups or pools. Each pool is assumed to be one unit for purposes of costing. One significant disadvantage to this pooled approach is that businesses must continuously redefine their pools and are subjected to a higher risk of invading LIFO layers.

6.3.2 LIFO Inventory Methods Based on Dollar Value

Dollar-Value LIFO --Inventory increases and decreases are determined and measured in terms of total dollar value. New layers are formed only when the ending inventory at base-year prices exceed the beginning inventory at base-year prices. Layers are computed based on price indexes, which adjusts base-year prices to current-year prices or vice versa. The indexes include, but are not limited to:

Consumer Price Index for Urban Consumers (and other published price indexes by the government, commodity exchange, or trade associations).

Double-Extension Method -- units in inventory are extended at both base-year prices and current-year prices, by dividing current-year amounts by the base-year amounts to arrive at the LIFO index. (Example A at S Corp Chapter 6.5).

Link-Chain Method -- base cost of ending inventory is determined by applying a cumulative index to the dollar value of the ending inventory. The cumulative index is the relationship of the current-year prices to those of the prior year multiplied by the prior year's cumulative index; thus each year's index may be characterized as a link in a chain of indexes back to the base year.

LIFO Retail --A LIFO inventory method that converts cost to retail by applying markups and markdowns to goods purchased during the current period and not to the beginning period.

6.4 EXAMPLE OF LIFO COMPUTATION - SINGLE GOOD PHYSICAL QUANTITY METHOD

Example A

	LIFO Layer Increments			LIFO Layer Invasions			
Year	Units	Cost/Unit	Subtotal	Units	Cost/Unit	Subtotal	LIFO Value
1994	22,000	5.00	$110,000				$110,000
1995	5,000	7.00	35,000				145,000
1996	8,000	12.00	96,000				241,000
1997	6,000	15.00	90,000				331,000
1998	2,000	17.00	34,000				365,000
1999				2,000	17.00	34,000	
				2,000	15.00	30,000	301,000

	LIFO Layer Increments			LIFO Layer Invasions			
Year	Units	Cost/Unit	Subtotal	Units	Cost/Unit	Subtotal	LIFO Value
2000				4,000	15.00	60,000	
				6,000	12.00	72,000	169,000
2001	3,000	22.00	66,000				235,000
2002				2,000	22.00	44,000	191,000

Explanation of Transactions:

1994 First year; ending inventory = 22,000 units.
1995 Ending inventory = 27,000 units; 5,000 unit layer created (27,000 EOY - 22,000 BOY).
1996 Ending inventory = 35,000 units; 8,000 unit layer created (35,000 EOY - 27,000 BOY).
1997 Ending inventory = 41,000 units; 6,000 unit layer created (41,000 EOY - 35,000 BOY).
1998 Ending inventory = 43,000 units; 2,000 unit layer created (43,000 EOY - 41,000 BOY).
1999 Ending inventory = 39,000 units; complete invasion (liquidation) of 1998 layer (2,000 units) and partial invasion of 1997 layer (2,000 units).
2000 Ending inventory = 29,000 units; complete invasion (liquidation) of remaining 1997 layer (4,000 units) and partial invasion of 1996 layer (6,000 units).
2001 Ending inventory = 32,000 units; 3,000 unit layer created (32,000 EOY - 29,000 BOY).
2002 Ending inventory = 31,000 units; partial invasion of 2001 layer (2,000 units).

6.5 COMPUTING LIFO RECAPTURE AMOUNT AND TAX

The following conditions must be met in order to assess the LIFO Recapture Tax for California purposes:

- The corporation was a C corporation for its last taxable year before the first taxable year in which the California S election was effective, and
- The corporation inventoried goods under the LIFO method for such last taxable year.

The LIFO recapture amount is defined as the inventory amount of the inventory assets under the First In, First Out (FIFO) method in excess of the inventory amount of such assets under the LIFO method as of the close of the last taxable year as a C corporation (IRC §1363(d)(3)(A)-(B)).

LIFO Recapture Amount = Inventory Calculated Using FIFO – Inventory Calculated Using LIFO

IRC §1363(d)(1) requires the above LIFO recapture amount to be included in the gross income of the corporation's last year as a C corporation with appropriate adjustments to the basis of the inventory to account for this LIFO recapture inclusion into gross income.

IRC §1363(d)(2) allows for the increase in tax relating to the inclusion of the LIFO recapture amount to be paid in 4 equal installments -- the first installment in its last year as a C corporation; the 3 remaining installments in the 3 succeeding taxable years.

Example A

In 1997, ABC, Inc. elected dollar-value, double-extension LIFO using the latest acquisitions method of determining current year cost.

On 1/1/03 it elected California S status effective beginning 1/1/03. Its LIFO inventory schedules were as follows:

Base-Year Layer	Base-Year Amounts	LIFO Index	Current-Year Amounts
Base	$1,400,000	1.00	$1,400,000

1997	400,000	1.20	480,000
1998	500,000	1.30	650,000
1999	200,000	1.35	270,000
2000	0	1.40	0
2001	400,000	1.50	600,000
2002	500,000	1.60	800,000
Total	$3,400,000		LIFO Carrying Value $4,200,000

ABC, Inc. can readily determine the LIFO recapture amount as of 12/31/02 since the FIFO method requires inventory to be valued at cost.

The FIFO amount is determined based on the following formula:

FIFO Amount ÷ Total Base Year Amounts = LIFO Index in the Final C Year

$$x \div \$3,400,000 = 1.60$$
$$x = 1.60 \times \$3,400,000$$
$$x = \$5,440,000$$

	FIFO Amount -		LIFO Carrying Value		
LIFO recapture amount =	$5,440,000	-	$4,200,000	=	$1,240,000

ABC, Inc. would report LIFO recapture income totaling $1,240,000 in IYE 12/02. Net income for California tax purposes before inclusion of the LIFO recapture amount was $3,500,000. Since California has a single franchise tax rate, unlike federals graduated corporate tax rates, coupled with the fact that ABC, Inc. reported net income for tax purposes before inclusion of the LIFO recapture amount, the additional tax attributable to the LIFO recapture amount in IYE 12/02 is $104,160 ($1,240,000 x 8.84%). This amount is required to be reported in 4 equal installments between IYE 12/02 -12/05.

If ABC, Inc. had reported a taxable loss of ($1,000,000) before inclusion of the $1,240,000 LIFO recapture amount, the additional tax attributable to inclusion of the LIFO recapture amount would have been $ 20,416

(($1,000,000) + 1,240,000) x 8.84% - $800 minimum franchise tax).

Adjustments to the basis of the inventory would be made to account for the $1,240,000 inclusion into income (regardless of whether additional tax was created):

LIFO Carrying Value + Recapture Amount = Adjusted Basis (FIFO)

$4,200,000 + $1,240,000 = <u>$5,440,000</u>

6.6 REVENUE PROCEDURE 94-61

Revenue Procedure 94-61, I.R.B. 1994-38,56, (Sep. 19, 1994) provides procedures for reporting the LIFO recapture amount as required by IRC §1363(d). This procedure states that the LIFO recapture amount is the amount by which the C Corporation's inventory under the FIFO method (determined by using cost or market, whichever is lower) authorized by IRC §471 exceeds the inventory amount under the LIFO method. This provision generally applies in the case of S elections made after December 17, 1987. Following are the procedures outlined in Rev. Proc. 94-61.

Question 1

Does inclusion of the LIFO recapture amount in gross income of a C corporation under IRC §1366(d) result in the termination or discontinuance of the LIFO method?

Answer 1

Inclusion of the LIFO recapture amount in gross income will not result in a termination or discontinuance of a taxpayer’s LIFO method. IRC §472(e) and Treas. Reg. §1.472-5 provide that an election made to adopt and use the LIFO method is irrevocable. The method, once adopted, shall be used in all subsequent taxable years, unless the use of another method is required by the Commissioner or authorized pursuant to a written application filed as provided in Treas. Reg. §1.446-1(e). Taxpayers complying with Rev. Proc. 88-15, 1988-1 C.B. 683 may expeditiously obtain the consent of the Commissioner to discontinue the use of the LIFO method.

Question 2

How does a taxpayer make the appropriate adjustment to the basis of inventory required by IRC §1363(d)(1)?

Answer 2

The appropriate method to effect the adjustment to the basis of inventory under IRC §1363(d)(1) is to collapse any LIFO layers and add the LIFO recapture amount to the LIFO value of the ending inventory as of the end of the taxpayer's last taxable year as a C corporation. Collapsing the LIFO layers is appropriate because (1) the revaluation of ending inventory to FIFO (using the lower of cost or market as of the date of conversion to S status) is inconsistent with the LIFO layering approach, and (2) IRC §1363(d) was enacted to create parity between LIFO and FIFO taxpayers when LIFO taxpayers elect to be taxed as S-Corporations.

The following example illustrates the appropriate method. Assume that a taxpayer elected LIFO in 1999, and the LIFO carrying value on December 31, 2002, is $1,600, which is comprised of the following layers:

	Base-Year Cost	Index	LIFO Carrying Value
01/01/99 base-year	$1,000	100%	$1,000
12/31/99 layer	200	110%	220
12/31/00	---	115%	---
12/31/01 layer	100	120%	120
12/31/02 layer	200	130%	260
	$1,500		$1,600

The above assumes that the taxpayer experienced a decrement for the year ending December 31, 2000, when the end-of-the-year inventory expressed in terms of base-year cost was less than the beginning-of-the-year inventory expressed in terms of base-year cost.

Further assume that the inventory is valued at $1,900 under the FIFO method using cost or market, whichever is lower. Therefore, if the taxpayer elected to be taxed as an S-Corporation effective January 1, 2003, the LIFO recapture amount is $300 ($1,900 less $1,600).

The appropriate adjustments are made by collapsing the LIFO layers and adding the $300 LIFO recapture amount to the LIFO carrying value of the ending inventory as of the end of the 2002 taxable year. The index is then changed to reflect the adjusted relationship between the new LIFO carrying value ($1,900) and base-year costs ($1,500). The base year and base-year costs do not change. Accordingly, the adjusted index and LIFO carrying value are as follows:

	Base-Year Cost	Index	LIFO Carrying Value
01/01/99 base-year	---	100%	---
12/31/99 layer	---	110%	---
12/31/00	---	115%	---
12/31/01 layer	---	120%	---
Layer resulting from IRC §1363(d) adjustment	$1,500	126.67%	$1,900

Note that the beginning inventory is $1,900 for the 2003 taxable year, which is the first year the taxpayer is taxed as an S-Corporation. Also, note that for a taxpayer using the link-chain method, the cumulative index is not recomputed. The cumulative index at December 31, 2002, is 130 percent, even though the adjusted index for the special collapsed layer resulting from the IRC §1363(d) adjustment is 126.67 percent. The cumulative index at December 31, 2002, will be the product of 130 percent and the annual link for the December 31, 2002 taxable year.

The above index for the special collapsed 2002 layer is relevant only for the purpose of computing the LIFO-carrying value of a decrement in the event there is a decrement to the LIFO inventory as of or prior to December 31, 2002, in a taxable year subsequent to the taxable year ending December 31, 2002. Thus, this index would be used only if the end-of-year inventory, expressed in terms of base-year cost for a taxable year subsequent to the taxable year ending December 31, 2002, is less that $1,500. For example, if, in 2003, the taxpayer’s ending inventory at base-year cost is $1,400 (a decrement of $100), the LIFO carrying value will decrease by $126.67 ($100 x 126.67%).

However, if a taxpayer has experienced a decrement in its LIFO inventory for a taxable year ending before September 19, 2005, the IRS will accept as appropriate any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount.

Question 3

If a taxpayer makes the appropriate adjustment to the tax basis of its inventory, as required by IRC §1363(d), but does not make such adjustment for financial reporting purposes, is the LIFO conformity requirement violated?

Answer 3

IRC §472(c) provides that the LIFO method may be used only if the taxpayer establishes that, with respect to the first taxable year for which the method is used, no other method of valuing inventory has been used in ascertaining income, profit, or loss for credit purposes or for a report or statement to shareholder, partners, other proprietors, or beneficiaries. IRC §472(e)(2) imposes similar restrictions for subsequent years.
Treas. Reg. §1.472-2(e)(1)(vi) provides that a taxpayer may use a costing method or accounting method to ascertain income, profit, or loss for credit purposes or for purposes of financial reports if such costing method or accounting method is neither inconsistent with the inventory method referred to in Treas. Reg. §1.472-1 nor at variance with the requirement referred to in Treas. Reg. § 1.472-1(c), regardless of whether such costing method or accounting method is used by the taxpayer for federal income tax purposes. Treas. Reg. §1.472-1 refers to the LIFO inventory method. Treas. Reg. §1.472-2(c) provides rules for the opening inventory of the taxable year for which the LIFO method is first used.

A taxpayer that uses a method for costing its LIFO inventory for financial reporting purposes without taking into account the basis adjustment under IRC §1363(d) made to its LIFO inventory for tax purposes is neither inconsistent with the LIFO inventory method referred to in Treas. Reg. §1.472-1 nor at variance with the requirement referred to in Treas. Reg. §1.472-2(c). Accordingly, the taxpayer does not violate the LIFO conformity requirement contained in §472(c) or §472(e)(2) by making the appropriate adjustment to the basis of its inventory for tax purposes but not for financial reporting purposes.

Question 4

Is a taxpayer entitled to reduce its gross income if the amount of its inventory under the LIFO method exceeds the amount of its inventory under the FIFO method?

Answer 4

The taxpayer may not reduce gross income if the amount of its inventory under the LIFO method exceeds the amount of its inventory under the FIFO method. IRC §1363(d)(3) states that "the term 'LIFO recapture amount' means the amount (if any)" by which the inventory amount of the inventory asset under the FIFO method exceeds the amount of such asset under the LIFO method. If the amount of inventory under the LIFO method exceeds the amount of inventory under the FIFO method, there is no LIFO recapture amount to include in gross income.

Question 5

May a net operating loss (NOL) carryover be applied against the LIFO recapture amount included in the gross income of a C corporation?

Answer 5

Subject to applicable code restriction, an NOL carryover may be applied against the LIFO recapture amount included in the gross income of the C corporation. To the extent the NOL carryover offsets the LIFO recapture amount, there would be no increase in tax by reason of IRC §1363(d). However, the appropriate adjustment to the basis of inventory required under IRC §1363(d) is the LIFO recapture amount unreduced by the NOL carryover.

Question 6

If the LIFO method has been used for less than four taxable years prior to a taxpayer's first year as an S-Corporation, should the number of, or period over which, installment payments for the additional tax resulting from the LIFO recapture amount be reduced from the four equal installment required in IRC §1363(d)(2)?

Answer 6

Neither the number of installments nor the period for their payment should be reduced. Under IRC §1363(d)(2), any increase in the tax imposed as a result of including the LIFO recapture amount in gross income shall be payable in four equal installment with the first installment being paid by the due date of the return for the electing corporation's last taxable year as a C corporation. The other three installments are due by the respective due dates of the S-Corporation's returns for the three succeeding taxable years without regard to the number of years the C corporation may have used the LIFO method.

Question 7

Should an S-Corporation's obligation to pay an installment of tax resulting from the LIFO recapture amount be taken into account in determining the amount of estimated tax an S-Corporation is required to pay?

Answer 7

An S-Corporation should not include the obligation to pay an installment of tax resulting from the LIFO recapture amount in its determination of its estimated tax payment under IRC §6655.

Question 8

If an S-Corporation files a final return, are any unpaid annual installments of the increase in tax required under IRC §1363(d) (that otherwise would be payable in subsequent taxable years) due and payable with the S-Corporation's final return?

Answer 8

Any remaining unpaid annual installments of the increase in tax resulting from the application of IRC §1363(d), which would have been due by the respective due dates of the S-Corporation's returns for the succeeding taxable year, are accelerated and are due and payable with the S-Corporation's final return.

6.7 DETERMINING THE ADDITIONAL TAX DUE TO LIFO RECAPTURE

For Federal purposes the LIFO Recapture Tax is reported on Federal Form 1120, Line 31, which comes from the computation on Federal Form J, Line 11.

However, since the LIFO Recapture is paid through installments you must compute the amount of the deferred tax before calculating the amount per Schedule J, Line 11 of Federal Form 1120.

How to compute the amount of Deferred LIFO Recapture Tax:

Step 1.	Compute the tax on the corporation's income including the LIFO recapture amount, by completing Schedule J Lines 1 – 10, but do not enter a total on line 11 yet.
Step 2.	Then recompute the tax on the corporation's income, but do not include the LIFO recapture amount into the corporation's taxable income, by completing a second Schedule J Lines 1 – 10, and not entering a total on line 11.
Step 3.	Then compare the tax amounts from Step 1 to the tax in Step 2. (The difference between these two amounts is the LIFO recapture tax.
Step 4.	Multiply the amount from Step 3 by 75%, this is the amount of the deferred LIFO recapture tax.)

Reporting the LIFO Recapture Tax. The taxpayer should attach a schedule showing the computation referenced above. Then on the dotted line next to Schedule J, Line 11, they should specify (a) the applicable Code section, (b) the type of tax, and (c) the amount of tax.

Example, if the corporation is deferring $3,000 of LIFO recapture tax, subtract this amount from the total on Schedule J, Line 11, then enter "IRC §1363-Deferred Tax-$3,000" on the dotted line next to amount.

(The above instructions is reference to the 2005 Federal Form 1120)

On the California return for the subsequent three tax years, the LIFO Recapture Tax is reported on Form 100S, Schedule J, Line 1, which then is reported on Form 100S, Line 36 or 37, which ever is applicable. On Line 36 or 37, the taxpayer should write "Schedule J" to the left of the amount.

(The above instructions is reference to the 2005 CA Form 100S)

6.8 TREATMENT OF LIFO HELD BY A PARTNERSHIP "LOOKTHROUGH RULE"

6.8.1 Overview

Treas. Reg. 1.1363-2 provides guidance for situations where a C-Corporation owns LIFO inventory through a partnership (or through tiered partnerships) and converts to an S-Corporation or when a C-Corporation transfers a partnership interest to an S-Corporation in a nonrecognition transaction.

The regulation is effective for S-corporation elections and transfers made after August 13, 2004.

Under regulation 1.1363-2(b) – When a C-Corporation holds LIFO inventory indirectly through a partnership, it must include the "Lookthrough" LIFO recapture amount (as defined below) in its gross income:

1. In its last tax year as a C-Corporation if, on the last day of the corporation's last tax year before its S-Corporation election became effective, the corporation held a lookthrough partnership interest (as defined by paragraph (c)(3) of this section); or

2. In the year of the transfer by the C-Corporation to an S-Corporation, if the corporation transferred its Lookthrough partnership interest to the S-Corporation in a Code Sec. 7701(a)(45) nonrecognition transaction in which the transferred interest constituted transferred basis property described at Code Sec. 7701(a)(43) .

A partnership interest is a Lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the LIFO method (LIFO inventory). Reg. §1.1363-2(c)(3).

A corporation's Lookthrough LIFO recapture amount is determined as of the end of the recapture date where a C-Corporation elects S-Corporation status and as of the moment before the transfer where a C-Corporation transfers its Lookthrough partnership interest to a S-Corporation in a nonrecognition transaction. Reg. §1.1363-2(c)(2).

A corporation's Lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation (taking into account the Code Sec. 704(c) rules applicable to built-in gain or loss on contributed property) if the partnership had sold all of its LIFO inventory for the inventory's FIFO value.

The Lookthrough LIFO recapture amount is generally determined as of the end of the recapture date. However, if the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the Lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's tax year that includes the recapture date.

For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date.

A partnership that applies this alternative method to calculate the Lookthrough LIFO recapture amount must take into account any adjustments to the partnership's basis in its LIFO inventory that result from transactions occurring after the start of the partnership's tax year and before the end of the recapture date, including adjustments to the basis of LIFO inventory during that period under Code Sec. 734(b) (relating to partnership distributions), Code Sec. 737(c) (relating to distributions to a partner who contributed built-in gain property), or Code Sec. 751(b) (relating to deemed sales of hot assets). Reg. §1.1363-2(c)(4).

6.8.2 Recapture Dates

Where a C-Corporation elected S-Corporation status, the recapture date is the day before the effective date of the S-Corporation election.

Where a C-Corporation transferred assets to an S-Corporation in a nonrecognition transaction, the recapture date is the date of the transfer of the partnership interest to the S-Corporation. Reg. §1.1363-2(c)(1).

6.8.3 Basis Adjustments

Appropriate adjustments to the basis of the corporation's partnership interest are made to reflect any amount of Lookthrough LIFO recapture included in income. Reg. §1.1363-2(e)(2)(i).

A partnership directly holding LIFO inventory taken into account in determining the Lookthrough LIFO recapture may elect to adjust the basis of that LIFO inventory. A partnership holding, through another partnership, LIFO inventory taken into account in determining a Lookthrough LIFO recapture may also elect to adjust the basis of that partnership interest.

The amount of the adjustment to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment to the basis of a partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to that interest. A basis adjustment under this rule is treated in the same manner and has the same effect as a basis adjustment under Code Sec. 743(b) (see Reg. §1.743-1(j)). Reg. §1.1363-2(e)(2)(ii).

The election for a partnership to adjust the basis of its inventory as a result of the Lookthrough provisions is made by attaching a statement to its original or amended income tax return for the first tax year ending on or after (1) the date of the S-Corporation election or (2) after the tax free transfer to the S-Corporation. This statement must state that the partnership was electing under Reg. §1.1363-2(e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax as described above and of the partnership, as well as the amount of the adjustment and the portion of the adjustment attributable to each pool of inventory or Lookthrough partnership interest held by the partnership. Reg. §1.1363-2(e)(3).

6.8.4 Example 1

K is a C-Corporation with a fiscal tax year ending on June 30. KH is a partnership with a calendar year end that is 20% owned by K and 80% owned by H, an individual. On April 25, 2005, K contributed LIFO inventory to KH, increasing K's interest in the partnership to 50%. KH holds no other LIFO inventory, and there are no other adjustments to the partnership's basis in its LIFO inventory between Jan. 1, 2005 and the end of the recapture date.

K elects to be an S-Corporation effective July 1, 2005. The recapture date is June 30, 2005. KH elects to use the LIFO method for the inventory and determines that the FIFO and LIFO values of the opening inventory for KH's 2005 tax year, including the inventory contributed by K, is $200 and $120, respectively.

KH does not have to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, KH may determine the Lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership 2005 tax year, which includes the recapture date. For this purpose, the opening inventory will include the inventory contributed by K.

The amount by which the FIFO value ($200) exceeds the LIFO value ($120) in KH's opening inventory is $80. Thus, if KH sold all of the LIFO inventory at the FIFO value of $200, it would recognize $80 of income.
Therefore, K's Lookthrough LIFO recapture amount is $40, the amount of income that would be allocated to K (50% of %$80. Thus, K must include $40 into income in its tax year ending on June 30, 2005 and will increase its

basis in its interest in KH by $40. KH may elect to increase the basis (with respect to K only) of its LIFO inventory by $40. Reg.§1.1363-2(f).

6.8.5 Example 2

J is a C-Corporation with a calendar year end. JP is a calendar year end partnership, which is 30% owned by J. JP owns LIFO inventory that is not Code Sec. 704(c) property. J elects to be an S-Corporation effective Jan. 1, 2005. The recapture date is Dec. 31, 2004. JP determines that the FIFO and LIFO values of the inventory on Dec. 31, 2005 are $240 and $140, respectively.

The amount that FIFO exceeded LIFO is $100. Therefore, If JP sold all of its LIFO inventory for it's FIFO value of $240, it would recognize $100 of income. J's Lookthrough LIFO recapture amount would be $30, the amount of income that would be allocated to J if JP sold all of its LIFO inventory for the FIFO value (30% of $100).

Thus, J must include $30 in income in its tax year ending on Dec. 31, 2004 and J will increase its basis in its interest in JP by $30. JP may elect to increase the basis (with respect to J only) of its inventory by $30. Reg. §1.1363-2(f)

6.8.6 Prior Law:

For S-Corporation elections and transfers before Aug. 13, 2004, the above rules on treatment of LIFO inventory held by a partnership did not apply. Reg. §1.1363-2(g)(3). Instead, the Eleventh Circuit, reversing the Tax Court, held that, where a C-Corporation held limited partnership interests in partnerships with LIFO inventory, the corporation's LIFO recapture amount did not include the corporation's pro rata share of the partnerships' inventory. Coggin Automotive Corp v. Com., (2002, CA11) 89 AFTR 2d 2002-2826, 292 F3d 1326, 2002-1 USTC ¶50448, revg (2000) 115 TC 349.

6.9 MISCELLANEOUS ISSUES

The LIFO recapture amount, included into income in the last C-Corporation year, increases C-Corporation earnings & profits. This will impact the taxability of distributions made in future S-Corporation years when distributions exceed AAA.

If the corporation did not include, in whole or part, the LIFO recapture amount into income in its last C-Corporation year but was subject to such provisions, the C-Corporation earnings & profits should include the portion omitted from income in the last C-Corporation year.

The LIFO recapture tax provisions also apply when a C-Corporation using the LIFO inventory method is merged into an S-Corporation in a nonrecognition transaction.