

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Kurt Vanden Bosch, Revenue Agent
(Grand Rapids)

from: Associate Area Counsel (Detroit)
(Large Business & International)

subject: Reporting and Payment of LIFO recapture

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Subsidiary =
LLC =
S Corp =
Corp =
Date 1 =
Date 2 =
Year 1 =
Year 2 =

ISSUES

1. Should the LIFO recapture amount have been reported on the final consolidated return for Taxpayer?

2. Was the single-transaction return filed by TAXPAYER to report the LIFO recapture amount a proper return?
3. Can consolidated net operating losses generated in the tax year ended Date 1 be used to offset the LIFO recapture income?
4. Can the Service now assess the LIFO recapture tax, interest and penalties shown on the single-transaction return?
5. What procedures should be followed with respect to the erroneous refund?

CONCLUSIONS

1. Under 1363(d)(4)(D), TAXPAYER could not be treated as a member of the affiliated group with respect to the LIFO recapture amount.
2. The single-transaction return was a valid return necessitated by 1363(d)(4)(D).
3. Under 1363(d)(4)(D), consolidated operating losses may not be used to offset the LIFO recapture amount.
4. The Service can assess the amount that was reported on the TAXPAYER single-transaction return and paid with that return.
5. TAXPAYER should return the uncashed erroneous refund check to the Service. No interest should be charged on the erroneous refund.

FACTS

Taxpayer ("TAXPAYER") was a C corporation and the common parent of a consolidated group of C corporations. The TAXPAYER group had subsidiaries:

, and Subsidiary ("SUBSIDIARY"). TAXPAYER also owned, directly or indirectly, several disregarded entities. Only two of the entities owned by TAXPAYER used the LIFO inventory method: (1) LLC, an entity treated as a disregarded entity (part of TAXPAYER) for federal income tax purposes; and (2) SUBSIDIARY, one of the C corporation members of the TAXPAYER consolidated group.

TAXPAYER entered into a merger agreement with ("S CORP"). S CORP was an S corporation since its formation. According to the Merger Agreement, TAXPAYER merged with CORP, a corporation wholly owned by S CORP. Pursuant to the merger, the separate existence of CORP ceased, leaving TAXPAYER as the surviving corporation in the merger. The merger was effective at 11:59pm on the Closing Date, which was Date 1.

Because TAXPAYER was the surviving corporation, the merger did not terminate the TAXPAYER tax year or the TAXPAYER consolidated group. According to the

Agreement and Plan of Merger, the transaction was treated as a stock purchase by S CORP for federal income tax purposes.

In _____, S CORP filed qualified subchapter S subsidiary (“Qsub”) elections for TAXPAYER and its subsidiaries. According to the Merger Agreement, the Qsub elections were to be effective on the date immediately following the Closing Date, i.e. Date 2. Agreement and Plan of Merger 10.6(e). It is our understanding that Exam agrees the effective date of the Qsub elections for TAXPAYER and its subsidiaries was Date 2.

TAXPAYER filed a short-period consolidated Form 1120 for the period from _____ through Date 1 (the “short-period return”). Effective Date 2, TAXPAYER was included in the consolidated Form 1120S filed by S CORP.

The parties agree that the Qsub elections which were effective on Date 2 triggered a LIFO recapture amount. However, the parties to the merger disputed the proper reporting of the LIFO recapture amount. The short-period consolidated Form 1120 originally filed by TAXPAYER excluded the LIFO recapture amount. However, pursuant to an arbitrator’s findings, TAXPAYER later filed a non-consolidated return for a stated period beginning and ending Date 1 (the “single-transaction return”). TAXPAYER reported 100% of the LIFO recapture amount, and paid 25% of the associated tax, on the single-transaction return. TAXPAYER paid \$ _____ including tax, late filing penalty, late payment penalty, and interest with the single-transaction return. The single-transaction return was not processed by the IRS Service Center. It was returned to the taxpayer because a return covering Date 1 and including TAXPAYER (the short-period return) had already been filed. The Service Center processed the \$ _____ payment but soon after issued TAXPAYER a refund check for the \$ _____, which TAXPAYER did not cash and continues to hold.

The significance of this issue from the Service’s perspective is that the TAXPAYER short-period return reflected a net operating loss which was carried back. TAXPAYER filed refund claims for the tax years ended _____, Year 1 and _____, Year 2. The refund claims have not yet been paid. This is a Joint Committee case due to the size of the claimed refunds. The refund claims would have been reduced if the LIFO recapture income had been included in the short-period consolidated return rather than the single-transaction return.

LAW AND ANALYSIS

Section 1363(d)(1) provides that a C corporation that accounts for its inventory using the LIFO method and elects S corporation status must include a “LIFO recapture amount” in gross income for the last taxable year before its S election becomes effective. Thus, TAXPAYER must include a LIFO recapture amount in gross income for its last taxable year before the Date 2 Qsub election date. TAXPAYER’s last taxable

year before the S election ended on Date 1. Thus, it is reportable by TAXPAYER for the year ending Date 1.

Under § 1363(d)(3), the LIFO recapture amount is the excess of the inventory amount of the inventory assets under the first-in, first-out method over the inventory amount of the assets under the LIFO method. The inventory amounts are determined as of the close of the taxable year prior to the taxable year in which the taxpayer's S election becomes effective.

Section 1363(d)(2) requires payment of the additional tax that is attributable to the inclusion of the LIFO recapture amount in gross income in four equal installments. The first installment payment must be made on or before the due date of the electing corporation's last income tax return as a C corporation. An additional installment must be paid on or before the due date of the corporation's return for each of the three succeeding taxable years.

The recapture date is the day before the effective date of the S election. Treas. Reg. § 1.1363-2(c)(1). However, with reference to transactions described in § 1.1363-2(a)(2) (including Qsub elections), there appears to be a typo in the regulations. Treas. Reg. § 1.1363-2(c)(1) states that for a nonrecognition transaction described in § 1.1363-2(a)(2) or (b)(2), the recapture date is the "date of the transfer of the partnership interest to the S corporation." However, only section (b)(2) refers to a transfer of a partnership interest, (a)(2) refers to transfers of LIFO inventory assets by the C corporation to an S corporation. The LIFO recapture amount is determined as of the end of the recapture date for S corporation elections described in § 1.1363-2(a)(1), and as of the moment before the transfer occurs for nonrecognition transactions (including Qsub elections) described in 1.1363-2(a)(2). Treas. Reg. § 1.1363-2(c)(2).

An S corporation can elect to treat a wholly-owned domestic corporation as a qualified subchapter S subsidiary "Qsub". Section 1361(b)(3). A Qsub is not treated as a separate corporation; all assets, liabilities, and items of income, deduction and credit of a Qsub are treated as items of the S corporation. In this case, S CORP elected to treat the TAXPAYER consolidated group, including TAXPAYER and SUBSIDIARY, as Qsubs.

On its face, Section 1363(d)(1) does not apply to an electing Qsub, it refers only to an "S corporation [that] was a C corporation...". However, the regulations support the conclusion that LIFO recapture applies to a Qsub election as well as an S corporation election. Treas. Reg. § 1.1363-2(a) provides that a C corporation must include the LIFO recapture amount in the year of transfer by the C corporation to an S corporation in a nonrecognition transaction¹ in which the transferred assets constitute transferred basis property. A Qsub election is treated as if the electing corporation transferred all its assets to its parent in a Section 332 liquidation. Treas. Reg. § 1.1361-4(a)(2). A

¹ For this purpose, a "nonrecognition transaction" is defined by Section 7701(a)(45) as any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

Section 332 liquidation is a nonrecognition transaction in which the distributee's basis in the transferred property is generally the same as the transferor's basis. See Section 334(b)(1). Thus, LIFO recapture applies to a Qsub election as well as an S corporation election.

When a Qsub election is made, the subsidiary is deemed to have liquidated into the S corporation. § 1.1361-4(a)(2). The liquidation occurs at the close of the day before the Qsub election is effective. Treas. Reg. § 1.1361-4(b)(1). When Qsub elections for a tiered group of subsidiaries are effective on the same date, the S corporation may specify the order of the liquidations. Treas. Reg. § 1.1361-4(b)(2). If no order is specified, the liquidations that are deemed to occur as a result of the Qsub elections will be treated as occurring first for the lower-tier entity and proceed successively upward. Id. The Agreement and Plan of Merger did not specify the order of liquidations.

The Qsub elections were effective on Date 2. Thus, SUBSIDIARY was deemed to liquidate first, and transfer its inventory to TAXPAYER, on Date 1. On this date, TAXPAYER was still a C corporation. Therefore, LIFO recapture does not apply to the liquidation of SUBSIDIARY into TAXPAYER, because the distributee in that deemed liquidation was not an S corporation. However, the subsequent deemed liquidation of TAXPAYER into S CORP on Date 1 did trigger LIFO recapture, because TAXPAYER was deemed to liquidate into S CORP which was an S corporation at the time of the deemed liquidation.

Consolidated return rules

The liquidation of all the members of the TAXPAYER affiliated group did not terminate the TAXPAYER consolidated group. See Rev. Rul. 74-483, 1974-2 C.B. 285 (liquidation of the sole subsidiary member of an affiliated group does not prevent the filing of a consolidated return). However, the liquidation of the common parent TAXPAYER terminated the TAXPAYER consolidated group.

A consolidated return must include the common parent's items of income, gain, deduction, loss and credit for the entire consolidated return year, and each subsidiary's items for the portion of the year for which it is a member. § 1.1502-76(b)(1)(i). Section 1.1502-76(b)(1)(ii) provides that when a corporation (other than a former S corporation) becomes or ceases to be a member during a consolidated year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day (the "end of day rule"). TAXPAYER correctly filed a consolidated tax return for the period ending on Date 1, the date TAXPAYER was deemed to liquidate and cease its existence as common parent.

Section 1.1502-76(b)(1) provides generally that if the consolidated return includes the items of a corporation for only a portion of its tax year, items for the portion of the year not included in the consolidated return must be included in a separate return, in such a manner to prevent the duplication or elimination of the corporation's items. Although

this provision does not directly address the situation at hand, it provides support for the filing of a separate return for a corporation's income which cannot properly be included in the consolidated return.

Single-Transaction Return Requirement

Section 1363(d)(4)(D) does not operate to exclude the converting company from the consolidated group for all purposes, or for a specific date or period; rather, it provides that the converting company is not a member of the affiliated group "with respect to the amount included in gross income under paragraph (1)." Hence, TAXPAYER properly filed a consolidated return, but also properly reported the LIFO recapture income on a return separate from the affiliated group's consolidated income. However the regulations do not explain how this provision should be implemented in practical terms.

Because under Section 1363(d)(4)(D) TAXPAYER could not be treated as a member of an affiliated group with respect to the recapture amount, the arbitrator concluded that TAXPAYER could not include LIFO recapture income on its final consolidated return and was therefore required to report the LIFO recapture income on a separate "single transaction" return. In the treatise *Consolidated Tax Returns*, § 23:6 ("One-day problem for S corporations"), author Lawrence Axelrod² similarly concluded that "the corporation is required to file a separate return that includes only the LIFO recapture amount." We believe this is the correct treatment.

The fact that TAXPAYER was the common parent of the consolidated group and not just a member should not change the result. Congress intended for the LIFO recapture tax to be imposed on the converting corporation, not on the affiliated group. See S.Rept. 100-445, at 438 (1988).³ Section 1363(d)(4)(D) provides that for purposes of Section 1363(d), the electing corporation shall not be treated as a member of an affiliated group with respect to the LIFO recapture amount. Thus, a converted C corporation that was a member of an affiliated group which filed a consolidated return cannot use a consolidated loss to offset any tax liability attributable to the LIFO recapture amount. See I.R.C. § 1363(d)(4)(D), Coggin Automotive Corporation v. Commissioner, 292 F.3d 1326 (11th Cir. 2002).⁴

The consolidated short-period return filed for the period ending on Date 1 was a valid return and TAXPAYER was properly included in that return. As a result, the single-

² Mr. Axelrod is currently Special Counsel to Associate Chief Counsel (Corporate).

³ The Senate Report provides: "It is intended that in the case of a converting C corporation that was previously a member of an affiliated group filing a consolidated return, and whose last taxable year as a C corporation would for other purposes be its last taxable year as a member of the group, the converting corporation, and not the group of corporations with which it filed a consolidated return during its last taxable year as a C corporation, would be liable for any tax attributable to the recognition of the LIFO recapture amount." S.Rept. 100-445, at 438 (1988)

⁴ In Coggin, the Court found that a taxpayer incurs no tax liability for recapture of a subsidiary's LIFO reserves when it elects S corporation status. Thus, a holding company which had no LIFO inventory reserves of its own could not be held liable for the LIFO recapture tax of an entity it owned.

transaction return filed by TAXPAYER, which stated that it was for a tax year beginning Date 1, and ending on Date 1, was rejected as a duplicate return. The single-transaction return was not a “true duplicate” return (see IRM 21.7.9.4.1.3) as to Date 1 because it was received with a payment and reported a transaction excluded from the originally filed return. It was also not an amended return in the usual sense, because it was not intended to alter the amounts reported on the short-period consolidated return. The single-transaction return was more in the nature of a supplemental return, because it addressed the tax liability of one of the same entities (TAXPAYER) and dates (Date 1) as the previous return, but contained additional item not reportable on the original consolidated return.

In essence, TAXPAYER filed one required return as common parent of a consolidated return and which reflected part of its total tax liability; a second required return was then filed with payment of its remaining tax liability as a converting Qsub. This treatment appears proper because the LIFO recapture amount was reportable by TAXPAYER, the LIFO recapture amount could not be included on the consolidated TAXPAYER return, and therefore a separate return was required to report the LIFO recapture amount.

Authority to Assess Tax Paid

Section 6501(a) provides that the amount of any tax shall be assessed within three years after the return was filed. The original return controls the statute of limitations and an amended return is not a return for purposes of § 6501(a); an amended return is simply a modification or supplement to the original return, and not a return in its own right. Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934). The statute remains open with respect to the Date 1 return.

The Service is authorized to assess all taxes determined by the taxpayer on a return. See Section 6201(a)(1), Treas. Reg. § 301.6201-1(a)(1). This includes any amount on an amended return. The single-transaction return filed by TAXPAYER meets the definition of “return.” The term “return” includes any return, statement, schedule, or list, and any amendment or supplement thereto, filed with respect to any income tax. § 6213(g)(1). Treas. Reg. § 301.6211(a)-1 provides that “[a]ny amount shown as additional tax on an ‘amended return’ filed after the due date of the return, shall be treated as an amount shown by the taxpayer ‘upon his return’ for purposes of computing the amount of a deficiency.” In this case, when the original and supplemental TAXPAYER returns are considered together, the \$ does not constitute a “deficiency” within the meaning of § 6211(a) for the relevant period. The Service is authorized to assess the \$ LIFO recapture tax without initiating deficiency proceedings.

Furthermore, any amount paid as a tax or in respect of a tax may be assessed upon the receipt of such payment. § 6213(b)(4). The \$ was paid as a tax, and therefore the Service was authorized to assess this amount upon receipt. Although this amount was not previously assessed, the Service may, at any time within the period prescribed

for assessment, make a supplemental assessment whenever it is ascertained that any assessment is imperfect or incomplete in any material respect. § 6204(a).

The Service is not prohibited from collecting and retaining taxes voluntarily paid without assessment. Ewing v. United States, 914 F.2d 499, 503-4 (4th Cir. 1990). Nor is the assessment a condition precedent to the liability. A taxpayer can be liable for a tax and make payment for that tax even though the tax is not assessed. A tax liability exists independent of its assertion in a notice of deficiency or assessment. See Goldston v. United States, 104 F.3d 1198, 1199-1200 (10th Cir. 1997); United States v. Latham, 754 F.2d 747, 750 (7th Cir. 1985); Marvel v. United States, 719 F.2d 1507, 1514 (10th Cir. 1983). The assessment simply acts as a lien or judgment for taxes found due. Bull v. United States, 295 U.S. 247, 259 (1935).

In sum, the statute of limitations remains open, the LIFO recapture tax was shown on a return filed by the taxpayer, and the LIFO recapture tax was paid with that return. Thus, the Service may proceed with assessing the amount included on the single-transaction return and paid with that return.

Recovery of erroneous refund

Under section 6402(a), the Service may issue a refund only if the taxpayer has made an overpayment. Neither the Internal Revenue Code nor the regulations provide a definition of an overpayment.⁵ The Supreme Court has stated that an overpayment is a payment in excess of what properly should have been assessed and collected as tax. Jones v. Liberty Glass Co., 332 U.S. 524, 531 (1947) (“[T]he payment of more than is rightfully due is what characterizes an overpayment.”). Thus, the payment of properly owed taxes within the statutory period of limitations is not an overpayment even if there is no corresponding assessment. Crompton & Knowles Loom Works v. White, 65 F.2d 132 (1st Cir.), cert. den., 290 U.S. 699 (1933); see also, Rev. Rul. 85-67, 1985-1 C.B. 364, citing Lewis v. Reynolds, 284 U.S. 281 (1932).

In this case, the taxpayer established its correct tax liability for the Date 1 year by filing an original and a supplemental single-transaction return. Because the taxpayer established and paid those liabilities in full prior to the expiration of period of limitations, there was no overpayment for the Date 1 year and the \$ refund was erroneous.

Section 6602 states that erroneous refunds bear interest “from the date of the payment of the refund.” The statute does not define the date of payment, but courts have held that interest on an erroneous refund runs from date the check was cashed, not from date checks were issued. See U.S. v. McMullen, Not Reported in F.Supp., 1970 WL 388

⁵ Section 6401 provides that certain amounts will be treated as overpayments. Specifically, it treats any amounts collected by the Service after the expiration of the period of limitations on assessment with no assessment having been made, as an overpayment. The overpayment is subject to a mandatory refund regardless of whether the taxpayer made the payment voluntarily or involuntarily. See Diamond Garner Corp v. Commissioner, 38 T.C. 875, 879-81 (1962).

(S.D.Ind.) Thus, no interest should be charged to TAXPAYER during the period that it held the check uncashed.

* * *

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Please call (313) 628-3113 if you have any further questions.

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