

Part I

Section 1374.—Tax Imposed on Certain Built-In Gains

26 CFR 1.1374-4: Recognized built-in gain or loss.

Rev. Rul. 2001-50

ISSUE

Is the S corporation's gain recognized in each of the situations described below recognized built-in gain for purposes of § 1374 of the Internal Revenue Code?

FACTS

Situation 1: An S corporation holds timber property with built-in gain on the date its election to convert from a C corporation to an S corporation is effective (or acquires timber property with built-in gain from a C corporation in a transaction to which § 1374(d)(8) applies). During the 10-year period beginning with the first day of the first taxable year for which the corporation was an S corporation (or beginning on the day of the § 1374(d)(8) transaction) (the recognition period) the S corporation cuts the timber and sells the resulting wood products and recognizes that built-in gain in a transaction to which § 631 does not apply.

Situation 2: An S corporation holds timber property with built-in gain on the date its election to convert from a C corporation to an S corporation is effective (or acquires timber property with built-in gain from a C corporation in a transaction to which § 1374(d)(8) applies). During the recognition period, the S corporation recognizes that built-in gain on cutting the timber pursuant to an election under § 631(a).

Situation 3: An S corporation holds timber property with built-in gain on the date its election to convert from a C corporation to an S corporation is effective (or acquires

timber property with built-in gain from a C corporation in a transaction to which § 1374(d)(8) applies). During the recognition period, the S corporation recognizes that built-in gain on the disposal of the timber under a contract to which § 631(b) applies.

Situation 4: An S corporation holds coal or domestic iron ore property with built-in gain on the date its election to convert from a C corporation to an S corporation is effective (or acquires coal or domestic iron ore property with built-in gain from a C corporation in a transaction to which § 1374(d)(8) applies). During the recognition period, the S corporation recognizes that built-in gain on the disposal of the coal or domestic iron ore under a contract to which § 631(c) applies.

LAW AND ANALYSIS

Section 1374 imposes a corporate-level tax on an S corporation's net recognized built-in gain during the recognition period in the case of a C corporation's conversion to S corporation status (§ 1374(a)) or an S corporation's acquisition of assets in a transaction in which the S corporation's basis in the acquired assets is determined by reference to the basis of such assets in the hands of a C corporation (§ 1374(d)(8)). Recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation establishes that it did not hold the asset on the conversion date or § 1374(d)(8) transaction date, or that the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the conversion date or § 1374(d)(8) transaction date (§ 1374(d)(3)). Section 1374(d)(3) applies to any gain recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes (§ 1.1374-4(a) of the Income Tax Regulations). In Example 1 of § 1.1374-4(a)(3), X is a C corporation that elects to become an S corporation effective January 1, 1996. On

that date, X owns a working interest in an oil and gas property with a fair market value of \$250,000 and an adjusted basis of \$500,000. During the recognition period, X produces and sells oil extracted from the oil and gas property for \$75,000. The example concludes that the \$75,000 is not recognized built-in gain under § 1374 because, as of the beginning of the recognition period, X held only a working interest in the oil and gas property, and not the oil itself.

Section 631(a) provides that, under certain circumstances, a taxpayer's cutting of timber is treated as a sale or exchange of the timber in the year it is cut. Section 631(b) provides that, under certain circumstances, a taxpayer's disposition of timber shall be treated as giving rise to gain or loss on a sale of such timber. Section 631(c) provides that, under certain circumstances, a taxpayer's disposition to unrelated parties of coal or domestic iron ore shall be treated as giving rise to gain or loss on a sale of such coal or iron ore. In general, § 631 permits a taxpayer to benefit from capital gain treatment in circumstances that would otherwise give rise to ordinary income.

If an S corporation holds timber property on the date its election to convert from a C corporation to an S corporation is effective and, during the recognition period, cuts the timber and sells the resulting wood products in a transaction to which § 631 does not apply, the tax consequences to the S corporation under § 1374 are determined using the same analysis contained in Example 1 of § 1.1374-4(a)(3). The wood products sold as inventory during the recognition period did not constitute separate assets held by the S corporation on the conversion date and thus their production and sale do not constitute a partial disposition of the timber property. See Rev. Rul. 72-515, 1972-2 C.B. 466 (treating growing timber as part of the underlying real property for purposes of § 1031). Accordingly, the S corporation's income on the sale of the

resulting wood products during the recognition period is not recognized built-in gain within the meaning of § 1374(d)(3) and is not taxed under § 1374.

Notwithstanding the treatment accorded income under § 631, the income received from the sale of the resulting wood product, produced coal, or produced iron ore involves the receipt of normal operating business income in the nature of rent or royalties. See Rev. Rul. 77-109, 1977-1 C.B. 87 (holding that payments received from a disposal of coal to which § 631(c) does not apply is ordinary income). The receipt of normal operating business income in the nature of rents and royalties is not subject to tax under § 1374. There is no indication that Congress intended the capital gain tax rate benefits provided by section § 631 to cause normal operating business income from the cutting of timber or the extraction of minerals to be subject to tax under § 1374. Moreover, § 631(c) is designed to favor domestic production of iron ore and sales of coal and iron ore to unrelated parties. Applying § 1374 to income taxed under § 631(c) could have the anomalous effect of taxing sales of domestic iron ore more heavily than sales of foreign production and taxing sales of coal and iron to unrelated parties more heavily than sales to related parties. Accordingly, an S corporation's gain recognized pursuant to § 631(a), § 631(b), or § 631(c) during the recognition period is not recognized built-in gain within the meaning of § 1374(d)(3).

HOLDINGS

The S corporation's gain recognized in the transactions described in Situation 1, 2, 3, and 4 is not recognized built-in gain for purposes of § 1374.

See also Rev. Proc. 2001-51, 2001-43 I.R.B. ___, which modifies Rev. Proc. 2001-3, 2001-1 I.R.B. 111, by deleting therefrom section 5.06 (the no-rule under § 1374, regarding the tax imposed on certain built-in gains).

DRAFTING INFORMATION

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