Argo Sales Co. v. Commissioner, 105 T. C. 86 (1995)

Section 481(a) adjustments attributable to periods before an S corporation election are treated as recognized built-in gains subject to tax under Section 1374.

Summary

Argo Sales Co. switched from the cash to the accrual method of accounting, necessitating a Section 481(a) adjustment of $1,336,966. 63 to be spread over six years. After three years, Argo elected S corporation status. The IRS argued the remaining adjustments were built-in gains under Section 1374, taxable at the corporate level. The Tax Court agreed, holding that Section 481(a) adjustments are income items attributable to pre-S corporation periods, thus subject to the built-in gains tax. This decision impacts how corporations transitioning to S status must account for prior accounting method changes.

Facts

Argo Sales Co. , an Ohio corporation, changed its accounting method from cash to accrual in 1985 due to its inventory holdings, requiring a Section 481(a) adjustment of $1,336,966. 63. This adjustment was spread over six years as per Rev. Proc. 85-36. Argo included one-sixth of the adjustment in its income for the fiscal years ending March 31, 1986, 1987, and 1988. Effective April 1, 1988, Argo elected S corporation status. The remaining three-sixths of the Section 481(a) adjustment were included in Argo’s S corporation income for the short year ending December 31, 1988, and calendar years 1989 and 1990.

Procedural History

The IRS determined deficiencies for the tax years 1988, 1989, and 1990, asserting that the Section 481(a) adjustments were subject to the built-in gains tax under Section 1374. Argo petitioned the U. S. Tax Court, which upheld the IRS’s position, ruling that the adjustments constituted built-in gains.

Issue(s)

1. Whether Section 481(a) adjustments are items of income attributable to periods before the first year for which the corporation was an S corporation, within the meaning of Section 1374(d)(5).

2. Whether the prospective application of Section 1. 1374-4(d) of the Income Tax Regulations prevents the Commissioner from applying Section 1374 to Argo’s Section 481(a) adjustments for the years at issue.

Holding

1. Yes, because Section 481(a) adjustments are income items that arise from the

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period before the S corporation election, and thus are subject to the built-in gains tax under Section 1374(d)(5).

2. No, because the prospective application of the regulation does not preclude the Commissioner from interpreting and applying the statute to the years at issue based on its legislative history and text.

Court's Reasoning

The court reasoned that Section 1374(d)(5) treats any item of income attributable to periods before the S corporation election as a recognized built-in gain if taken into account during the recognition period. The Section 481(a) adjustment, representing untaxed corporate income from before the S election, fits this description. The court noted the legislative history of Section 1374, which broadly defined "recognized built-in gain" to include income items beyond just the disposition of assets. The court rejected Argo's argument that the prospective effective date of Section 1. 1374-4(d) of the regulations precluded the Commissioner from applying Section 1374 to the years in question. The court found that the absence of regulations did not relieve it of the duty to interpret the statute, and that the statute's text and legislative history supported the IRS's position. The court concluded that the Section 481(a) adjustments were properly subject to the built-in gains tax under Section 1374.

Practical Implications

This decision clarifies that Section 481(a) adjustments must be considered when analyzing the built-in gains tax implications for corporations converting to S status. Practitioners should advise clients to account for any such adjustments when planning an S election, as they will be subject to the built-in gains tax. The ruling prevents corporations from using a change in accounting method to avoid corporate-level tax on pre-conversion income. Businesses contemplating a switch to S corporation status should carefully review their accounting method changes and potential Section 481(a) adjustments. Subsequent cases have cited Argo in determining the scope of built-in gains, affirming its application to various types of pre-conversion income.

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