

S corporation LIFO recapture tax

Dear Reader:

You recently informed me that you are considering converting your C corporation to an S corporation. Since you have been using the LIFO inventory method, I want to make sure that you are aware of the LIFO recapture income that will be triggered by converting to S corporation status. We should get together soon to compute what the tax on this recapture would be and to see what planning steps might be taken to minimize it.

As you are aware, your corporation has been reporting a lower amount of taxable income under LIFO than it would have under FIFO because the inventory taken into account in calculating the cost of goods sold under LIFO reflects current costs, which are usually higher. This benefit of LIFO over FIFO is equal to the difference between the LIFO value of inventory and the higher value it would have had if the FIFO method had been used. In effect, the tax law treats this difference as though it were profit earned while the corporation was a C corporation. To make sure there's a corporate-level tax on this amount, it must be "recaptured" into income when the corporation converts from a C corporation to an S corporation. Also, the recapture amount will increase the corporation's earnings and profits, which can have adverse tax consequences down the road.

There are a couple of rules that soften the blow of this recapture tax somewhat. The increase in tax imposed on the C corporation in its final tax year because of the LIFO recapture may be paid over a four-year period. And, the basis of the corporation's inventory will be increased by the amount of income recognized. So, the net effect may be one primarily of timing—because of the basis increase, the corporation may realize less income in later years, though only if there are decrements in the adjusted LIFO layer.

We can help you gauge your exposure to the LIFO recapture tax and can suggest strategies for reducing it.

