Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

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Refer Reply To:
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March 8, 2001

Legend

Company =

State =

D1 =

D2 =

Year 1 =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

Amount 6 =

Percentage 1 =
Percentage 2 =
a =

b =

c =

n1 =

n2 =

This responds to a letter dated November 1, 2000, together with subsequent correspondence, submitted on behalf of Company, requesting certain rulings regarding the formation of a limited liability company ("LLC") described below. Generally, the requested rulings involve the consequences of the Company's transfer of last-in, first-out ("LIFO") inventory property to a newly formed LLC.

The rulings contained in this letter are predicated upon facts and representations submitted by Company and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data may be required as a part of the audit process.

Facts

Company is an S corporation that was formed under the laws of State on D1. Company maintains its accounting records and files its federal income tax returns using the accrual method of accounting. Company owns and operates n1 automobile dealerships, each of which is operated as a separate division.

Company uses the LIFO method to value its inventories and has two LIFO pools - one for new cars and demonstrators, and another for parts and accessories. Company uses the Alternative LIFO Method described in Revenue Procedure 97-36, 1997-2 C.B. 450, to value its inventories of new cars and demonstrators, and the link-chain LIFO Method to value its inventories of parts and accessories.

On D2, Company's aggregate inventory of new cars and demonstrators had an actual cost of Amount 1, LIFO value of Amount 2, and a LIFO reserve of Amount 3. The LIFO reserve measured as a percentage of the actual cost is Percentage 1. The corresponding amounts for the parts and accessories inventory were Amount 4, Amount 5, Amount 6, and Percentage 2. The Company's inventory LIFO cost is attributable to purchases at market prices and not "bargain" purchases.

According to Company, the success of a motor vehicle dealership depends largely upon the effectiveness of its general manager. In this case, Company has represented that its a, b, and c dealerships have been successfully managed. Therefore, Company wants to retain the general manager of its a, b, and c dealerships, and, as an incentive to retain such manager, offer the manager the opportunity to purchase an ownership interest in the a, b, and c dealerships.

However, Company owns n2 other dealerships. Therefore, if the general manager were to buy an interest in Company in order to acquire an interest in the dealership he manages, the value of his ownership interest would be tied to the

success or failure of the other dealerships over which he has no direct responsibility or control.

In order for the general manager to acquire an interest in only the a, b, and c dealerships, Company has organized an LLC. Company represents that the LLC will be classified as a partnership under Treas. Reg. § 301.7701-3 of the Procedure and Administration Regulations. Company proposes to contribute the net assets of the a, b, and c dealerships, including its LIFO inventories that have a fair market value in excess of their basis, to the LLC in exchange for a membership interest. Company will stay in existence and maintain a majority ownership interest in the profits and capital of the LLC, as well as continue to operate the remaining dealerships as separate divisions.

The opening inventory of the LLC will consist of the transferred LIFO inventory. Company represents that the LLC will adopt the double-extension LIFO method to value its new car and demonstrator inventory and the link-chain LIFO method to value its parts and accessories inventory. Company further represents that after the asset transfer, the amount of the LIFO reserve allocated to the inventories of the a, b, and c dealerships will approximate the same percentage of the actual cost as existed prior to the transfer.

After the asset transfer, the general manager will have supervisory authority over the same personnel and locations as before the transfer. It is expected that the general manager will contribute cash to the LLC for an ownership interest commensurate with the amount of his capital contribution compared to the total value of the capital of the LLC. Company represents that the capital accounts of the general manager will not be credited with amounts other than the cash contributed.

Law and Analysis

With respect to the proposed contribution of assets to the LLC in exchange for membership interests we rule as follows:

1. Section 721(a) provides that neither a partner nor a partnership will recognize gain or loss on a contribution of assets to a partnership in exchange for a partnership interest. Because Company will contribute assets to the LLC in exchange for a membership interest, Company will not recognize gain or loss on the contributions.

2. Section 1.721-1(b)(1) of the Income Tax Regulations provides, in relevant part, that to the extent that any partner gives up any part of his right to be repaid his contributions in favor of another partner as compensation for services, section 721 does not apply. However, in this case the general manager is making a cash contribution to the LLC in return for an ownership interest proportionate to the cash contributed, and is not receiving an interest in return for services rendered. Accordingly, to the extent the

manager's membership interest is received in exchange for cash contributed to the LLC, the manager will not recognize gain or loss on the contribution.

3. The contribution of the LIFO inventory property to the LLC formed to qualify for partnership tax treatment will not trigger recapture of the LIFO reserve. See section 721(a) .

4. A taxpayer may elect to use the LIFO method of inventorying goods provided certain conditions are satisfied. See section 472(a) . One of the conditions is that an application to use the LIFO method is filed in such manner as the Secretary may prescribe. Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership. See section 703(b). Therefore, in order to adopt the dollar-value LIFO inventory method, the transferee LLC must file a Form 970 and otherwise comply with the provisions of section 472 and the regulations thereunder.

5. Section 704(c) provides that income, gain, loss and deduction with respect to property contributed to a partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of the contribution.

Section 1.704-3(e)(2)(iii) provides that for partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets, may be aggregated for purposes of making allocations under section 704(c) if contributed by one partner during the partnership taxable year.

Property contributed to a partnership at a time when its book value differs from the contributing partners's tax basis is section 704(c) property. See section 1.704-3(a)(3)(i). For this purpose, book value equals fair market value at the time of contribution. The excess of the property's book value over the contributing partner's adjusted tax basis is the amount of the built-in gain on the contributed property.

Company has represented that the LLC will elect, under section 1.704-3(e)(2)(iii), to aggregate each item of inventory for purposes of making allocations under section 704(c). The transferee LLC shall treat those items included in its opening inventory as having been acquired at the same time and determine their cost by the average cost method as provided by section 472(b)(3). In determining its LIFO inventory at the close of the first taxable year, the LLC shall treat those goods specified in the application as being: first, those included in opening inventory to the extent thereof; and second, those acquired in the taxable year. See section 472(b).

The LIFO inventories contributed to the LLC constitute section 704(c) property, and any built-in gain or loss attributable to the inventories contributed by Company must be allocated back to Company when the LLC recognizes that gain or loss.

6. The Tax Court has ruled that goods may be in separate item categories because they have substantially dissimilar characteristics, whether in terms of their physical nature or whether in terms of their cost. See Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120, 136 (1991). In Hamilton, the entire base-year inventory of the taxpayer was composed of inventory purchased at substantial discount from its fair market value. The court found that treating the bargain-purchase goods as the same item as later-acquired inventory would distort income because the cost characteristics were greatly disparate. For that reason the court held that the purchased inventory should be treated as different items for LIFO inventory purposes.

In this case, Company has represented that it will contribute the net assets of the a, b, and c dealership, including its LIFO inventories, to the LLC in exchange for a membership interest. Company has also represented that the LIFO cost of the transferred inventory is not due to a "bargain purchase."

Although we recognize that requiring separate item treatment does not specifically tax the Company's transfer of inventory to the LLC, we believe that a different position would frustrate the underlying purpose of section 721. If the LLC were required to treat the transferred LIFO inventory as separate items from physically identical goods subsequently acquired, the non-recognition benefit of section 721 would be lost immediately due to the fact that the low carryover basis inventory would flow through the transferee's cost of goods sold and significantly increase gross income from the sale of merchandise in the year of transfer. Accordingly, the LLC is not required to treat the goods received from the Company and physically identical goods subsequently acquired as separate items solely because of the relatively low carryover basis of the transferred inventory.

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and the regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings.

A copy of this letter should be attached to the federal income tax returns of Company and the transferee LLC for the taxable year in which the transaction covered by this ruling is consummated.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,
Matthew Lay
Assistant to the Branch Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes