M, mutually agreeing that, in consideration of, and notwithstanding, any contrary provisions contained in the first contract, M shall not pay A more than $100x in any one calendar year. Under this supplemental contract, sums in excess of $100x accruing in any one calendar year are to be carried over by M into succeeding years. For the calendar year 1971, royalties payable to A under the basic agreement amount to $100x and this sum is paid to A. For the calendar year 1972, royalties of $120x are payable to A under the basic agreement, but by reason of the supplemental agreement, only $100x of this sum is actually paid to A. For each of the calendar years 1973 and 1974, royalties of $100x are payable to A under the basic agreement, and this sum is paid to A. For the calendar year 1975, royalties of $80x are payable to A under the basic agreement, and this sum, plus $20x carried over from 1972, or $100x, is paid to A. The $100x paid to A in each of the years 1971, 1972, 1973, and 1974, and $80x of the $100x paid to A in 1975 constitute earned income. The additional $20x carried over from 1972 and paid to A in 1975 constitutes deferred compensation under this paragraph (b) because it was paid to A later than the end of the year following the year (i.e., 1972) in which A's right to receive the amount was not subject to a substantial risk of forfeiture.

Example 15. Corporation M is the producer and owner of a feature length motion picture which is distributed to exhibitors by Corporation N pursuant to a distribution agreement between M and N providing for current payments to M of a given percentage of the current net profits derived by N from the exhibition and exploitation of the picture. A was employed by M as the leading actor in the picture for fixed compensation payable at the rate of $10x per week during the production period plus additional compensation equal to a given percentage of the net profits derived from the exhibition and exploitation of the picture. A's additional compensation is payable at the time that M receives payments from N under the terms of the distribution agreement. The additional compensation paid to A does not constitute deferred compensation since it is attributable to and measured by current net profits derived from the use of property created in part by A's efforts.

Example 16. A, a boxer entered into an agreement with M boxing club to fight a particular opponent on June 19, 1971. The agreement provided in part, that for his performance A was to receive 16 percent of the gross receipts derived from the match. Simultaneously, A and M executed a separate agreement providing for payment of A's share of the receipts from the match as follows: 25 percent thereof not later than August 15, 1971, and 25 percent thereof during each of the years 1972, 1973, and 1974 in equal semiannual installments. A's share of the gross receipts derived from the match was $100x, of which 25 percent was paid to him in 1971 and a total of $25x in each of the years 1972, 1973, and 1974. Under the particular facts and circumstances, A and M are not acting as partners or joint venturers. Thus, A is taxable upon his share of such gross receipts only in the years in which such share is actually paid to him under the terms of the separate agreement. The payments of $25x in each of the years 1971 and 1972 constitute earned income. The payments of $25x in each of the years 1973 and 1974 would not constitute earned income because they constitute deferred compensation received later than the end of the first taxable year (i.e., 1972) following the year in which A's right to receive such amounts was not subject to a substantial risk of forfeiture.

[T.D. 7446, 41 FR 55339, Dec. 20, 1976]

SMALL BUSINESS CORPORATIONS AND THEIR SHAREHOLDERS

§ 1.1361–0 Table of contents.

This section lists captions contained in §§ 1.1361–1, 1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6.

§ 1.1361–1 S Corporation defined.

§ 1.1361–2 Definitions relating to S corporation subsidiaries.

§ 1.1361–3 QSub election.

§ 1.1361–4 Effect of QSub election.

§ 1.1361–5 Termination of QSub election.

§ 1.1361–6 Effective date.

[T.D. 8600, 60 FR 37581, July 21, 1995, as amended by T.D. 8869, 65 FR 3848, Jan. 25, 2000; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9422, 73 FR 47527, Aug. 14, 2008]

§ 1.1361–1 S corporation defined.

(a) *In general.* For purposes of this title, with respect to any taxable year—

(1) The term *S corporation* means a small business corporation (as defined in paragraph (b) of this section) for which an election under section 1362(a) is in effect for that taxable year.

(2) The term *C corporation* means a corporation that is not an S corporation for that taxable year.

(b) *Small business corporation defined*—(1) *In general*. For purposes of subchapter S, chapter 1 of the Code and the regulations thereunder, the term *small business corporation* means a domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2)) and that does not have—

(i) More than the number of shareholders provided in section 1361(b)(1)(A);

(ii) As a shareholder, a person (other than an estate, a trust described in section 1361(c)(2), or, for taxable years beginning after December 31, 1997, an organization described in section 1361(c)(6)) who is not an individual;

(iii) A nonresident alien as a shareholder; or

(iv) More than one class of stock.

(2) *Estate in bankruptcy*. The term *estate*, for purposes of this paragraph, includes the estate of an individual in a case under title 11 of the United States Code.

(3) *Treatment of restricted stock*. For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of §1.83–3(f)) and that is substantially nonvested (within the meaning of §1.83–3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraphs (l) (1) and (3) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock.

(4) *Treatment of deferred compensation plans*. For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it—

(i) Does not convey the right to vote;

(ii) Is an unfunded and unsecured promise to pay money or property in the future;

(iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and

(iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

(5) *Treatment of straight debt*. For purposes of subchapter S, an instrument or obligation that satisfies the definition of straight debt in paragraph (l)(5) of this section is not treated as outstanding stock.

(6) *Effective date provision*. Section 1.1361–1(b) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, a corporation and its shareholders may apply this §1.1361–1(b) to prior taxable years. In addition, substantially nonvested stock issued on or before May 28, 1992, that has been treated as outstanding by the corporation is treated as outstanding for purposes of subchapter S, and the fact that it is substantially nonvested and no section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock.

(c) *Domestic corporation*. For purposes of paragraph (b) of this section, the term *domestic corporation* means a domestic corporation as defined in §301.7701–5 of this chapter, and the term *corporation* includes an entity that is classified as an association taxable as a corporation under §301.7701–2 of this chapter.

(d) *Ineligible corporation*—(1) *General rule*. Except as otherwise provided in this paragraph (d), the term *ineligible corporation* means a corporation that is—

(i) For taxable years beginning on or after January 1, 1997, a financial institution that uses the reserve method of accounting for bad debts described in section 585 (for taxable years beginning prior to January 1, 1997, a financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies);

(ii) An insurance company subject to tax under subchapter L;

(iii) A corporation to which an election under section 936 applies; or

(iv) A DISC or former DISC.

(2) *Exceptions.* See the special rules and exceptions provided in sections 6(c) (2), (3) and (4) of Public Law 97–354 that are applicable for certain casualty insurance companies and qualified oil corporations.

(e) *Number of shareholders*—(1) *General rule.* A corporation does not qualify as a small business corporation if it has more than the number of shareholders provided in section 1361(b)(1)(A). Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. For example, if stock (owned other than by a husband and wife or members of a family described in section 1361(c)(1)) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is generally considered to be a shareholder of the corporation. (For special rules relating to stock owned by husband and wife or members of a family, see paragraphs (e)(2) and (3) of this section, respectively; for special rules relating to restricted stock, see paragraphs (b)(3) and (6) of this section.) The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation. In addition, in the case of stock held for a minor under a uniform transfers to minors act or similar statute, the minor and not the custodian is the shareholder. Except as otherwise provided in paragraphs (h) and (j) of this section, and for purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate or a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate or trust (and not the beneficiaries of the estate or trust) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes a voting trust) or an electing QSST described in section 1361(d)(1), the deemed owner of the trust is considered to be the shareholder. If stock is held by an ESBT described in section 1361(c)(2)(A)(v), each potential current beneficiary of the trust shall be treated as a shareholder, except that the trust shall be treated as the shareholder during any period in which there is no potential current beneficiary of the trust. If stock is held by a trust described in section 1361(c)(2)(A)(vi), the individual for whose benefit the trust was created shall be treated as the shareholder. See paragraph (h) of this section for special rules relating to trusts.

(2) *Special rules relating to stock owned by husband and wife.* For purposes of paragraph (e)(1) of this section, stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a subpart E trust, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in section 7701(a)(31). The treatment described in this paragraph (e)(2) will cease upon dissolution of the marriage for any reason other than death.

(3) *Special rules relating to stock owned by members of a family*—(i) *In general.* For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor (without any generational limit), and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be

a common ancestor if, on the applicable date, the individual is more than six generations removed from the youngest generation of shareholders who would be members of the family determined by deeming that individual as the common ancestor. For purposes of this six-generation test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family (determined by deeming that individual as the common ancestor) holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

(ii) *Certain entities treated as members of a family*. For purposes of this paragraph (e)(3), the estate or trust (described in section 1361(c)(2)(A)(ii) or (iii)) of a deceased member of the family will be considered to be a member of the family during the period in which the estate or such trust (if the trust is described in section 1361(c)(2)(A)(ii) or (iii)), holds stock in the S corporation. The members of the family also will include—

(A) In the case of an ESBT, each potential current beneficiary who is a member of the family;

(B) In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;

(C) In the case of a trust created primarily to exercise the voting power of stock transferred to it, each beneficiary who is a member of the family;

(D) The individual for whose benefit a trust described in section 1361(c)(2)(A)(vi) was created, if that individual is a member of the family;

(E) The deemed owner of a trust described in section 1361(c)(2)(A)(i) if that deemed owner is a member of the family; and

(F) The owner of an entity disregarded as an entity separate from its owner under § 301.7701–3 of this chapter, if that owner is a member of the family.

(f) *Shareholder must be an individual or estate*. Except as otherwise provided in paragraph (e)(1) of this section (relating to nominees), paragraph (h) of this section (relating to certain trusts), and, for taxable years beginning after December 31, 1997, section 1361(c)(6) (relating to certain exempt organizations), a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

(g) *Nonresident alien shareholder*—(1) *General rule*. (i) A corporation having a shareholder who is a nonresident alien as defined in section 7701(b)(1)(B) does not qualify as a small business corporation. If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).

(ii) The following examples illustrate this paragraph (g)(1)(i):

Example 1. In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.

Example 2. Assume the same facts as *Example 1*, except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.

(2) *Special rule for dual residents*. [Reserved]

(h) *Special rules relating to trusts*—(1) *General rule*. In general, a trust is not a permitted small business corporation shareholder. However, except as provided in paragraph (h)(2) of this section, the following trusts are permitted shareholders:

(i) *Qualified subpart E trust*. A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner*. A trust that was a qualified subpart E trust immediately before the death of the deemed owner and that continues in existence after the death of the deemed owner, but only for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock pursuant to the terms of the will or the trust agreement, or if the trust continues to hold the stock during a period reasonably necessary to wind up the affairs of the trust. See §1.641(b)-3 for rules concerning the termination of trusts for federal income tax purposes.

(iii) *Electing qualified subchapter S trusts*. A qualified subchapter S trust (QSST) that has a section 1361(d)(2) election in effect (an electing QSST). See paragraph (j) of this section for rules concerning QSSTs including the manner for making the section 1361(d)(2) election.

(iv) *Testamentary trusts*. A trust (other than a qualified subpart E trust, an electing QSST, or an electing small business trust) to which S corporation stock is—

(A) Transferred pursuant to the terms of a will, but only for the 2-year period beginning on the day the stock is transferred to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section; or

(B) Transferred pursuant to the terms of an electing trust as defined in §1.645–1(b)(2) during the election period as defined in §1.645–1(b)(6), or deemed to be distributed at the close of the last day of the election period pursuant to §1.645–1(h)(1), but in each case only for the 2-year period beginning on the day the stock is transferred or deemed distributed to the trust except as otherwise provided in paragraph (h)(3)(i)(D) of this section.

(v) *Qualified voting trusts*. A trust created primarily to exercise the voting power of S corporation stock transferred to it. To qualify as a voting trust for purposes of this section (a qualified voting trust), the beneficial owners must be treated as the owners of their respective portions of the trust under subpart E and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that—

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.

(vi) *Electing small business trusts.* An electing small business trust (ESBT) under section 1361(e). See paragraph (m) of this section for rules concerning ESBTs including the manner of making the election to be an ESBT under section 1361(e)(3).

(vii) *Individual retirement accounts.* In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)), a trust which constitutes an individual retirement account under section 408(a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank or company as of October 22, 2004. Individual retirement accounts (including Roth IRAs) are not otherwise eligible S corporation shareholders.

(2) *Foreign trust.* For purposes of paragraph (h)(1) of this section, in any case where stock is held by a foreign trust as defined in section 7701(a)(31), the trust is considered to be the shareholder and is an ineligible shareholder. Thus, even if a foreign trust qualifies as a subpart E trust (e.g., a qualified voting trust), any corporation in which the trust holds stock does not qualify as a small business corporation.

(3) *Determination of shareholders*—(i) *General rule.* For purposes of paragraph (b) of this section (qualification as a small business corporation), and, except as provided in paragraph (h)(3)(ii) of this section, for purposes of sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholder's stock), and 1368 (relating to distributions), the shareholder of S corporation stock held by a trust that is a permitted shareholder under paragraph (h)(1) of this section is determined as follows:

(A) If stock is held by a qualified subpart E trust, the deemed owner of the trust is treated as the shareholder.

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 2-year period beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(C) If stock is held by an electing QSST, see paragraph (j)(7) of this section for the rules on who is treated as the shareholder.

(D) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day that the stock is transferred or deemed distributed to the trust. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of the QSST election, and the rules provided in paragraph (j)(7) of this section apply. If the trust qualifies and becomes an ESBT, the shareholders are determined under paragraphs (h)(3)(i)(F) and (h)(3)(ii) of this section as of the effective date of the ESBT election, and the rules provided in paragraph (m) of this section apply.

(E) If stock is held by a qualified voting trust, each beneficial owner of the stock, as determined under subpart E, is treated as a shareholder with respect to the owner's proportionate share of the stock held by the trust.

(F) If S corporation stock is held by an ESBT, each potential current beneficiary is treated as a shareholder. However, if for any period there is no potential current beneficiary of the ESBT, the ESBT is treated as the shareholder during such period. See paragraph (m)(4) of this section for the definition of potential current beneficiary.

(G) If stock in an S corporation bank or depository institution holding company is held by an individual retirement account (including a Roth IRA) described in paragraph (h)(1)(vii) of this section, the individual for whose benefit the trust was created shall be treated as the shareholder.

(ii) *Exceptions. See* §1.641(c)–1 for the rules for the taxation of an ESBT. Solely for purposes of section 1366, 1367, and 1368 the shareholder of S corporation stock held by a trust is determined as follows—

(A) If stock is held by a trust as defined in paragraph (h)(1)(ii) of this section (other than an electing QSST or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust is otherwise a permitted shareholder.

(B) If stock is transferred or deemed distributed to a testamentary trust described in paragraph (h)(1)(iv) of this section (other than a qualified subpart E trust, an electing QSST, or an ESBT), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 2-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(i) [Reserved]

(j) *Qualified subchapter S trust*—(1) *Definition.* A qualified subchapter S trust (QSST) is a trust (whether intervivos or testamentary), other than a foreign trust described in section 7701(a)(31), that satisfies the following requirements:

(i) All of the income (within the meaning of §1.643(b)–1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366. See §§1.651(a)–2(a) and 1.663(b)–1(a) for rules relating to the determination of whether all of the income of a trust is distributed (or is required to be distributed) currently. If under the terms of the trust income is not required to be distributed currently, the trustee may elect under section 663(b) to consider a distribution made in the first 65 days of a taxable year as made on the last day of the preceding taxable year. See section 663(b) and §1.663(b)–2 for rules on the time and manner for making the election. The income distribution requirement must be satisfied for the taxable year of the trust or for that part of the trust's taxable year during which it holds S corporation stock.

(ii) The terms of the trust must require that—

(A) During the life of the current income beneficiary, there will be only one income beneficiary of the trust;

(B) Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary;

(C) The current income beneficiary's income interest in the trust will terminate on the earlier of that income beneficiary's death or the termination of the trust; and

(D) Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.

(iii) The terms of the trust must satisfy the requirements of paragraph (j)(1)(ii) of this section from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period that the current income beneficiary and any successor income beneficiary is the income beneficiary of the trust. If the terms of the trust do not preclude the possibility that any of the requirements stated in paragraph (j)(1)(ii) of this section will not be met, the trust will not qualify as a QSST. For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.

(2) *Special rules*—(i) If a husband and wife are income beneficiaries of the same trust, the husband and wife file a joint return, and each is a U.S. citizen or resident, the husband and wife are treated as one beneficiary for purposes of paragraph (j) of this section. If a husband and wife are treated by the preceding sentence as one beneficiary, any action required by this section to be taken by an income beneficiary requires joinder of both of them. For example, each spouse must sign the QSST election, continue to be a U.S. citizen or resident, and continue to file joint returns for the entire period that the QSST election is in effect.

(ii)(A) *Terms of the trust and applicable local law*. The determination of whether the terms of a trust meet all of the requirements under paragraph (j)(1)(ii) of this section depends upon the terms of the trust instrument and the applicable local law. For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust.

(B) *Legal obligation to support*. If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See §1.677(b)–1 for rules on the treatment of trusts for support and §1.662(a)–4 for rules concerning amounts used in discharge of a legal obligation.

(C) *Example*. The following example illustrates the rules of paragraph (j)(2)(ii)(B) of this section:

Example: F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

(iii) If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361 (c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

(iv) If the terms of a trust or local law do not preclude the current income beneficiary from transferring the beneficiary's interest in the trust or do not preclude a person other than the current income beneficiary named in the trust instrument from being treated as a beneficiary of the trust under §1.643(c)–1, the trust will still qualify as a QSST. However, if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary's income interest and any person treated as a beneficiary under §1.643(c)–1 will be treated as a current income beneficiary for purposes of paragraph (j)(1)(ii) of this section and the trust may no longer meet the QSST requirements.

(v) If the terms of the trust do not preclude a person other than the current income beneficiary named in the trust instrument from being awarded an interest in the trust by the order of a court, the trust will qualify as a QSST assuming the trust meets the requirements of paragraphs (j)(1) (i) and (ii) of this section. However, if as a result of such court order, the trust no longer meets the QSST requirements, the trust no longer qualifies as a QSST and the corporation's S election will terminate.

(vi) A trust may qualify as a QSST even though a person other than the current income beneficiary is treated under subpart E as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock, provided the entire trust meets the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(3) *Separate and independent shares of a trust.* For purposes of sections 1361 (c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in paragraphs (j)(1) (i) and (ii) of this section.

(4) *Qualified terminable interest property trust.* If property, including S corporation stock, or stock of a corporation that intends to make an S election, is transferred to a trust and an election is made to treat all or a portion of the transferred property as qualified terminable interest property (QTIP) under section 2056(b)(7), the income beneficiary may make the QSST election if the trust meets the requirements set out in paragraphs (j)(1) (i) and (ii) of this section. However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677. If the grantor ceases to be the income beneficiary's spouse, the trust may qualify as a QSST if it otherwise satisfies the requirements under paragraphs (j)(1) (i) and (ii) of this section.

(5) *Ceasing to meet the QSST requirements.* If a QSST for which an election under section 1361(d)(2) has been made (as described in paragraph (j)(6) of this section) ceases to meet any of the requirements specified in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day on which that requirement ceases to be met. If such a trust ceases to meet the income distribution requirement specified in paragraph (j)(1)(i) of this section, but continues to meet all of the requirements in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet the income distribution requirement of paragraph

(j)(1)(i) of this section. If a corporation's S election is inadvertently terminated as a result of a trust ceasing to meet the QSST requirements, the corporation may request relief under section 1362(f).

(6) *Qualified subchapter S trust election*—(i) *In general.* This paragraph (j)(6) applies to the election provided in section 1361(d)(2) (the QSST election) to treat a QSST (as defined in paragraph (j)(1) of this section) as a trust described in section 1361(c)(2)(A)(i), and thus a permitted shareholder. This election must be made separately with respect to each corporation whose stock is held by the trust. The QSST election does not itself constitute an election as to the status of the corporation; the corporation must make the election provided by section 1362(a) to be an S corporation. Until the effective date of a corporation's S election, the beneficiary is not treated as the owner of the stock of the corporation for purposes of section 678. Any action required by this paragraph (j) to be taken by a person who is under a legal disability by reason of age may be taken by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent.

(ii) *Filing the QSST election.* The current income beneficiary of the trust must make the election by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement that—

(A) Contains the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation;

(B) Identifies the election as an election made under section 1361(d)(2);

(C) Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);

(D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(E) Provides all information and representations necessary to show that:

(*1*) Under the terms of the trust and applicable local law—

(*i*) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);

(*ii*) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;

(*iii*) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and

(*iv*) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.

(*2*) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.

(*3*) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

(iii) *When to file the QSST election.* (A) If S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. If a C corporation has made an election under section 1362(a) to be an S corporation (S election) and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

(B) If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is effective. If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year following the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is made. If a trust holds C corporation stock and that corporation makes an S election intending the S election to be effective for the first day of the taxable year in which the S election is made but, under §1.1362–6(a)(2), such S election is subsequently treated as effective for the first day of the taxable year following the taxable year in which the S election is made, the fact that the QSST election states that the effective date of the QSST election is the first day of the taxable year in which the S election is made will not cause the QSST election to be ineffective for the first year in which the corporation's S election is effective.

(C) If a trust ceases to be a qualified subpart E trust, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(i) of this section, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a testamentary trust is a permitted shareholder under paragraph (h)(1)(iv) of this section, satisfies the requirements of a QSST, and intends to become a QSST, the QSST election may be filed at any time, but no later than the end of the 16-day-and-2-month period beginning on the day after the end of the 2-year period.

(E) If a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief under section 1362(f). See §1.1362–4 for rules concerning inadvertent terminations.

(iv) *Protective QSST election when a person is an owner under subpart E.* If the grantor of a trust is treated as the owner under subpart E of all of the trust, or of a portion of the trust which consists of S corporation stock, and the current income beneficiary is not the grantor, the current income beneficiary may not make the QSST election, even if the trust meets the QSST requirements stated in paragraph (j)(1)(ii) of this section. See paragraph (j)(6)(iii)(C) of this section as to when the QSST election may be made. See also paragraph (j)(2)(vi) of this section. However, if the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) of a trust is treated under subpart E as owning all or a portion of the trust consisting of S corporation stock, the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) may make the QSST election. See *Example 8* of paragraph (k)(1) of this section.

(7) *Treatment as shareholder.* (i) The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

(8) *Coordination with grantor trust rules.* If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the Federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code. However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.

(9) *Successive income beneficiary.* (i) If the income beneficiary of a QSST who made a QSST election dies, each successive income beneficiary of that trust is treated as consenting to the election unless a successive income beneficiary affirmatively refuses to consent to the election. For this purpose, the term *successive income beneficiary* includes a beneficiary of a trust whose interest is a separate share within the meaning of section 663(c), but does not include any beneficiary of a trust that is created upon the death of the income beneficiary of the QSST and which is a new trust under local law.

(ii) The application of this paragraph (j)(9) is illustrated by the following examples:

Example 1. Shares of stock in Corporation X, an S corporation, are held by Trust A, a QSST for which a QSST election was made. B is the sole income beneficiary of Trust A. On B's death, under the terms of Trust A, J and K become the current income beneficiaries of Trust A. J and K each hold a separate and independent share of Trust A within the meaning of section 663(c). J and K are successive income beneficiaries of Trust A, and they are treated as consenting to B's QSST election.

Example 2. Assume the same facts as in *Example 1*, except that on B's death, under the terms of Trust A and local law, Trust A terminates and the principal is to be divided equally and held in newly created Trust B and Trust C. The sole income beneficiaries of Trust B and Trust C are J and K, respectively. Because Trust A terminated, J and K are not successive income beneficiaries of Trust A. J and K must make QSST elections for their respective trusts to qualify as QSSTs, if they qualify. The result is the same whether or not the trustee of Trusts B and C is the same as the trustee of trust A.

(10) *Affirmative refusal to consent*—(i) *Required statement.* A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that—

(A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;

(B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and

(C) Sets forth the date on which the successive income beneficiary became the income beneficiary.

(ii) *Filing date and effectiveness.* The affirmative refusal to consent must be filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

(11) *Revocation of QSST election.* A QSST election may be revoked only with the consent of the Commissioner.

The Commissioner will not grant a revocation when one of its purposes is the avoidance of Federal income taxes or when the taxable year is closed. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure. The application must be signed by the current income beneficiary and must—

(i) Contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation with respect to which the QSST election was made;

(ii) Identify the election being revoked as an election made under section 1361(d)(2); and

(iii) Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.

(12) *Converting a QSST to an ESBT*. For a trust that seeks to convert from a QSST to an ESBT, the consent of the Commissioner is hereby granted to revoke the QSST election as of the effective date of the ESBT election, if all the following requirements are met:

(i) The trust meets all of the requirements to be an ESBT under paragraph (m)(1) of this section except for the requirement under paragraph (m)(1)(iv)(A) of this section that the trust not have a QSST election in effect.

(ii) The trustee and the current income beneficiary of the trust sign the ESBT election. The ESBT election must be filed with the service center where the S corporation files its income tax return. This ESBT election must state at the top of the document ''ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361–1(j)'' and include all information otherwise required for an ESBT election under paragraph (m)(2) of this section. A separate election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

(iv) The date on which the ESBT election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(k)(1) *Examples*. The provisions of paragraphs (h) and (j) of this section are illustrated by the following examples in which it is assumed that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *Terms of the trust*. In 1996, A and A's spouse, B, created an intervivos trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, A and B designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon A's death, the trust is to be divided into two separate parts; one part attributable to the assets A contributed to the trust and one part attributable to B's contributions. Before the trust is divided, and during the administration of A's estate, all trust income is payable to B. The part of the trust attributable to B's contributions is to continue in trust under the terms of which B is designated as the sole income beneficiary and retains the power to amend or revoke the trust. The part attributable to A's contributions is to be divided into two separate trusts both of which have B as the sole income beneficiary for life. One trust, the *Credit Shelter Trust*, is to be funded with an amount that can pass free of estate tax by reason of A's available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under §20.2056(b)–7(b)(3) is directed to make an election under section 2056(b)(7).

(ii) *Results after deemed owner's death*. On February 3, 1997, A dies and the portion of the trust assets attributable to A's contributions including the S stock contributed by A, is includible in A's gross estate under sections 2036 and 2038. During the administration of A's estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), A's estate is treated as the shareholder of the S corporation stock that was included in A's gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder. B's part of the trust continues to be a qualified subpart E trust of which B is the owner under sections 676 and 677. B, therefore, continues to be treated as the shareholder of the S corporation stock in that portion of the trust. On May 13, 1997, during the continuing administration of A's estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in A's gross estate is distributed to the Marital Trust and to the Credit Shelter Trust. A's estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). B, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust by July 28, 1997 (the end of the 16-day-and-2-month period beginning on the date the estate ceases to be treated as a shareholder) to have the trusts become permitted shareholders of the S corporation.

Example 2. (i) *Qualified subpart E trust as shareholder.* In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Trust ceasing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (i) of this *Example 2*, except that A dies without having exercised A's power to revoke. Upon A's death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). A's estate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1). A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST or ESBT election if the trust qualifies as a QSST or ESBT. However, until that time, because the trust continues in existence after A's death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If no QSST or ESBT election is made effective upon the expiration of the 2-year period, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

(iii) *Trust continuing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (ii) of this *Example 2*, except that the terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368. Since the trust qualifies as a QSST, B may make a protective QSST election under paragraph (j)(6)(iv) of this section.

Example 3. (i) *2-year rule under section 1361(c)(2)(A)(ii) and (iii).* F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

(ii) *Section 645 electing trust and successor trust.* Assume the same facts as in paragraph (i) of this *Example 3*, except that F's trust is a qualified revocable trust for which a valid section 645 election is made on October 1, 2003 (electing trust). Because under section 645 the electing trust is treated and taxed for purposes of subtitle A of the Code as part of F's estate, the trust may continue to hold the O stock pursuant to §1361(b)(1)(B), without causing the termination of Corporation O's S election, for the duration of the section

645 election period. However, on January 1, 2004, during the election period, the shares of stock in Corporation O are transferred pursuant to the terms of the electing trust to a successor trust. Because the successor trust satisfies the definition of a testamentary trust under paragraph (h)(1)(iv) of this section, the successor trust is a permitted shareholder until the earlier of the expiration of the 2-year period beginning on January 1, 2004, or the effective date of a QSST or ESBT election for the successor trust.

Example 4. (i) *QSST when terms do not require current distribution of income.* Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently.* Assume the same facts as in paragraph (i) of this *Example 4,* except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this *Example 4,* except that the events occur in 2003 and H dies on November 1, 2003, and the trust does not qualify as an ESBT. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 2003, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(B)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 2-year period beginning on November 1, 2003. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 2-year period. After the 2-year period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to L, J, or both on or before October 31, 2005, (the last day of the 2-year period) assuming that neither L nor J becomes the 76th shareholder of Corporation Q as a result of the distribution.

Example 5. QSST when current income beneficiary assigns the income interest to a person not named in the trust. On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's income interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on N's death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation R ceases to be an S corporation.

Example 6. QSST when terms fail to provide for distribution of trust assets upon termination during life of current income beneficiary. A contributes S corporation stock to a trust the terms of which provide for one income beneficiary, annual distributions of income, discretionary invasion of corpus only for the benefit of the income beneficiary, and termination of the trust only upon the death of the current income beneficiary. Since the trust can terminate only upon the death of the income beneficiary, the governing instrument fails to provide for any distribution of trust assets during the income beneficiary's life. The governing instrument's silence on this point does not disqualify the trust under section 1361(d)(3)(A) (ii) or (iv).

Example 7. QSST when settlor of trust retains a reversion in the trust. On January 10, 1996, M transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A) (ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the trust by M). See example (5) of §1.1001–2(c) of the regulations.

Example 8. QSST when the income beneficiary has the power to withdraw corpus. On January 1, 1996, F transfers stock of an S corporation to an irrevocable trust whose income beneficiary is F's son, C. Under the terms of the trust, C is given the noncumulative power to withdraw from the corpus of the trust the greater of $5,000 or 5 percent of the value of the corpus on a yearly basis. The terms of the trust meet the QSST requirements. Assuming the trust distributions are not in satisfaction of F's legal obligation to support C, the trust qualifies as a QSST. C (or if C is a minor, C's legal representative) must make the QSST election no later than March 16, 1996 (the end of the 16-day-and-2-month period that begins on the date the stock is transferred to the trust).

Example 9. (i) *Filing the QSST election.* On January 1, 1996, stock of Corporation T, a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, 1996, Corporation T files an election to be an S corporation that is to be effective for its taxable year beginning on January 1, 1996. In order for the S election to be effective for the 1996 taxable year, the QSST election must be effective January 1, 1996, and must be filed within the period beginning on January 1, 1996, and ending March 16, 1996 (the 16-day-and-2-month period beginning on the first day of the first taxable year for which the election to be an S corporation is intended to be effective).

(ii) *QSST election when the S election is filed late.* Assume the same facts as in paragraph (i) of this *Example 9,* except that Corporation T's election to be an S corporation is filed on April 1, 1996 (after the 15th day of the 3rd month of the first taxable year for which it is to be effective but before the end of that taxable year). Because the election to be an S corporation is not timely filed for the 1996 taxable year, under section 1362(b)(3), the S election is treated as made for the taxable year beginning on January 1, 1997. The QSST election must be filed within the 16-day-and-2-month period beginning on April 1, 1996, the date the S election was made, and ending on June 16, 1996.

Example 10. (i) *Transfers to QTIP trust.* On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce.* Assume the same facts as in paragraph (i) of this *Example 10,* except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted.* Assume the same facts as in paragraph (i) of this *Example 10,* except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

(2) *Effective date*—(i) *In general.* Paragraph (a) of this section, and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) apply to taxable years of a corporation beginning after

July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a) of this section and paragraphs (c) through (k) of this section (as contained in the 26 CFR edition revised April 1, 2003) do not apply, see §18.1361–1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995). However, paragraphs (h)(1)(vi), (h)(3)(i)(F), (h)(3)(ii), and (j)(12) of this section (as contained in the 26 CFR edition revised April 1, 2003) are applicable for taxable years beginning on and after May 14, 2002. Otherwise, paragraphs (b)(1)(ii), (f), (h)(1)(ii), (h)(1)(iv), (h)(3)(i)(B), (h)(3)(i)(D), (h)(3)(ii)(A), (h)(3)(ii)(B), (j)(6)(iii)(C), (j)(6)(iii)(D), (j)(7)(ii), and (k)(1) *Example 2*(ii) fourth and last sentences, *Example 3*, and *Example 4*(iii) of this section apply on and after July 17, 2003. Paragraphs (b)(1)(i), (e)(1), (e)(3), (h)(1)(vii), (h)(3)(i)(G), and the fifth sentence of paragraph (j)(8) are effective on *August 14, 2008*.

(ii) *Transition rules.* Taxpayers may apply paragraph (h)(1)(iv)(B) of this section on and after December 24, 2002, and before July 17, 2003, to treat a trust as a testamentary trust, but not during any period for which a QSST or ESBT election was in effect for the trust. In addition, the Internal Revenue Service will not challenge the treatment of a trust described in paragraph (h)(1)(iv)(B) of this section as a permitted shareholder of an S corporation for periods after August 5, 1997, and before the earlier of July 17, 2003, or the effective date of any QSST or ESBT election for that trust.

(iii) *Exception.* If a QSST has sold or otherwise disposed of all or a portion of its S corporation stock in a tax year that is open for the QSST and the income beneficiary but on or before July 21, 1995, the QSST and the income beneficiary may both treat the transaction as if the beneficiary was the owner of the stock sold or disposed of, and thus recognize any gain or loss, or as if the QSST was the owner of the stock sold or disposed of as described in paragraph (j)(8) of this section. This exception applies only if the QSST and the income beneficiary take consistent reporting positions. The QSST and the income beneficiary must disclose by a statement on their respective returns (or amended returns), that they are taking consistent reporting positions.

(l) *Classes of stock*—(1) *General rule.* A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

(2) *Determination of whether stock confers identical rights to distribution and liquidation proceeds*—(i) *In general.* The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to

be given appropriate tax effect in accordance with the facts and circumstances.

(ii) *State law requirements for payment and withholding of income tax.* State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (l)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

(iii) *Buy-sell and redemption agreements*—(A) *In general.* Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless—

(*1*) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and

(*2*) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights. For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

(B) *Exception for certain agreements.* Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of §1.83–3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

(C) *Safe harbors for determinations of book value.* A determination of book value will be respected if—

(*1*) The book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or

(*2*) The book value is used for any substantial nontax purpose.

(iv) *Distributions that take into account varying interests in stock during a taxable year.* A governing provision does not, within the meaning of paragraph (l)(2)(i) of this section, alter the rights to liquidation and distribution proceeds conferred by an S corporation's stock merely because the governing provision provides that, as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year. If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

(v) *Special rule for section 338(h)(10) elections.* If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and §1.338(h)(10)–1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

(vi) *Examples.* The application of paragraph (l)(2) of this section may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Determination of whether stock confers identical rights to distribution and liquidation proceeds. (i) The law of State A requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The Commissioner grants permission to S, a corporation, to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

(ii) The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S so that those rights are not identical. Accordingly, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock and does not qualify as a small business corporation.

Example 2. Distributions that differ in timing. (i) S, a corporation, has two equal shareholders, A and B. Under S's bylaws, A and B are entitled to equal distributions. S distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds.

(ii) Under paragraph (l)(2)(i) of this section, the difference in timing of the distributions to A and B does not cause S to be treated as having more than one class of stock. However, section 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.

Example 3. Treatment of excessive compensation. (i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

Example 4. Agreement to pay fringe benefits. (i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

Example 5. Below-market corporation-shareholder loan. (i) E is a shareholder of S, a corporation. S makes a below-market loan to E that is a corporation-shareholder loan to which section 7872 applies. Under section 7872, E is deemed to receive a distribution with respect to S stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the loan agreement is not a governing provision. Accordingly, S is not treated as having more than one class of stock by reason of the below-market loan to E.

Example 6. Agreement to adjust distributions for state tax burdens. (i) S, a corporation, executes a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax distributions.

(ii) The binding agreement relates to distribution or liquidation proceeds. The agreement is thus a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds so that those rights are not identical. Therefore, under paragraph (l)(2)(i) of this section, S is treated as having more than one class of stock.

Example 7. State law requirements for payment and withholding of income tax. (i) The law of State X requires corporations to pay state income taxes on behalf of nonresident shareholders. The law of State X does not require corporations to pay state income taxes on behalf of resident shareholders. S is incorporated in State X. S's resident shareholders have the right (for example, under the law of State X or pursuant to S's bylaws or a binding agreement) to distributions that take into account the payments S makes on behalf of its nonresident shareholders.

(ii) The payment by S of state income taxes on behalf of its nonresident shareholders are generally treated as constructive distributions to those shareholders. Because S's resident shareholders have the right to equal distributions, taking into account the constructive distributions to the nonresident shareholders, S's shares confer identical rights to distribution proceeds. Accordingly, under paragraph (l)(2)(ii) of this section, the state law requiring S to pay state income taxes on behalf of its nonresident shareholders is disregarded in determining whether S has more than one class of stock.

(iii) The same result would follow if the payments of state income taxes on behalf of nonresident shareholders are instead treated as advances to those shareholders and the governing provisions require the advances to be repaid or offset by reductions in distributions to those shareholders.

Example 8. Redemption agreements. (i) F, G, and H are shareholders of S, a corporation. F is also an employee of S. By agreement, S is to redeem F's shares on the termination of F's employment.

(ii) On these facts, under paragraph (l)(2)(iii)(B) of this section, the agreement is disregarded in determining whether all outstanding shares of S's stock confer identical rights to distribution and liquidation proceeds.

Example 9. Analysis of redemption agreements. (i) J, K, and L are shareholders of S, a corporation. L is also an employee of S. L's shares were not issued to L in connection with the performance of services. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels.

(ii) Under paragraph (l)(2)(iii)(B) of this section, the portion of the agreement providing for redemption of L's stock on termination of employment is disregarded. Under paragraph (l)(2)(iii)(A), the portion of the agreement providing for redemption of L's stock if S's sales fall below certain levels is disregarded unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(3) *Stock taken into account.* Except as provided in paragraphs (b) (3), (4), and (5) of this section (relating to restricted stock, deferred compensation plans, and straight debt), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account. For example, substantially nonvested stock with respect to which an election under section 83(b) has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical, within the meaning of paragraph (l)(1) of this section, to the rights conferred by the other outstanding shares of stock.

(4) *Other instruments, obligations, or arrangements treated as a second class of stock*—(i) *In general.* Instruments, obligations, or arrangements are not treated as a second class of stock for purposes of this paragraph (l) unless they are described in paragraph (l)(5) (ii) or (iii) of this section. However, in no event are instruments, obligations, or arrangements described in paragraph (b)(4) of this section (relating to deferred compensation plans), paragraphs (l)(4)(iii) (B) and (C) of this section (relating to the exceptions and safe harbor for options), paragraph (l)(4)(ii)(B) of this section (relating to the safe harbors for certain short-term unwritten advances and proportionally-held debt), or paragraph (l)(5) of this section (relating to the safe harbor for straight debt), treated as a second class of stock for purposes of this paragraph (l).

(ii) *Instruments, obligations, or arrangements treated as equity under general principles*—(A) *In general.* Except as provided in paragraph (l)(4)(i) of this section, any instrument, obligation, or arrangement issued by a corporation (other than outstanding shares of stock described in paragraph (l)(3) of this section), regardless of whether designated as debt, is treated as a second class of stock of the corporation—

(*1*) If the instrument, obligation, or arrangement constituters equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law; and

(*2*) A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in paragraph (b)(1) of this section.

(B) *Safe harbor for certain short-term unwritten advances and proportionately held obligations*—(*1*) *Short-term unwritten advances.* Unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time are not treated as a second class of stock for that taxable year, even if the advances are considered equity under general principles of Federal tax law. The failure of an unwritten advance to meet this safe harbor will not result in a second class of stock unless the advance is considered equity under paragraph (l)(4)(ii)(A)(*1*) of this section and a principal purpose of the advance is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(*2*) *Proportionately-held obligations.* Obligations of the same class that are considered equity under general principles of Federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. The obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under paragraph (l)(4)(ii)(A)(*2*) of this section.

(iii) *Certain call options, warrants or similar instruments*—(A) *In general.* Except as otherwise provided in this paragraph (l)(4)(iii), a call option, warrant, or similar instrument (collectively, call option) issued by a corporation is treated as a second class of stock of the corporation if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder or a potential transferee) and has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified. For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification. In addition, a call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of the underlying stock at the time of exercise.

(B) *Certain exceptions.* (*1*) A call option is not treated as a second class of stock for purposes of this paragraph (l) if it is issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation. This paragraph (l)(4)(iii)(B)(*1*) continues to apply if the call option is transferred with the loan (or if a portion of the call option is transferred with a corresponding portion of the loan). However, if the call option is transferred without a corresponding portion of the loan, this paragraph (l)(4)(iii)(B)(*1*) ceases to apply. Upon that transfer, the call option is tested under paragraph (l)(4)(iii)(A) (notwithstanding anything in that paragraph to the contrary) if, but for this paragraph, the call option would have been treated as a second class of stock on the date it was issued.

(*2*) A call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock for purposes of this paragraph (l) if—

(*i*) The call option is nontransferable within the meaning of § 1.83–3(d); and

(*ii*) The call option does not have a readily ascertainable fair market value as defined in § 1.83–7(b) at the time the option is issued.

If the call option becomes transferable, this paragraph (l)(4)(iii)(B)(*2*) ceases to apply. Solely for purposes of this paragraph (l)(4)(iii)(B)(*2*), a corporation is related to the issuing corporation if more than 50 percent of the total voting power and total value of its stock is owned by the issuing corporation.

(*3*) The Commissioner may provide other exceptions by Revenue Ruling or other published guidance.

(C) *Safe harbor for certain options.* A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

(iv) *Convertible debt.* A convertible debt instrument is considered a second class of stock if—

(A) It would be treated as a second class of stock under paragraph (l)(4)(ii) of this section (relating to instruments, obligations, or arrangements treated as equity under general principles); or

(B) It embodies rights equivalent to those of a call option that would be treated as a second class of stock under paragraph (l)(4)(iii) of this section (relating to certain call options, warrants, and similar instruments).

(v) *Examples.* The application of this paragraph (l)(4) may be illustrated by the following examples. In each of the examples, the S corporation requirements of section 1361 are satisfied except as otherwise stated, the corporation has in effect an S election under section 1362, and the corporation has only the shareholders described.

Example 1. Transfer of call option by eligible shareholder to ineligible shareholder. (i) S, a corporation, has 10 shareholders. S issues call options to A, B, and C, individuals who are U.S. residents. A, B, and C are not shareholders, employees, or independent contractors of S. The options have a strike price of $40 and are issued on a date when the fair market value of S stock is also $40. A year later, P, a partnership, purchases A's option. On the date of transfer, the fair market value of S stock is $80.

(ii) On the date the call option is issued, its strike price is not substantially below the fair market value of the S stock. Under paragraph (l)(4)(iii)(A) of this section, whether a call option is a second class of stock must be redetermined if the call option is transferred by a person who is an eligible shareholder under paragraph (b)(1) of this section to a person who is not an eligible shareholder under paragraph (b)(1) of this section. In this case, A is an eligible shareholder of S under paragraph (b)(1) of this section, but P is not. Accordingly, the option is retested on the date it is transferred to D.

(iii) Because on the date the call option is transferred to P its strike price is 50% of the fair market value, the strike price is substantially below the fair market value of the S stock. Accordingly, the call option is treated as a second class of stock as of the date it is transferred to P if, at that time, it is determined that the option is substantially certain to be exercised. The determination of whether the option is substantially certain to be exercised is made on the basis of all the facts and circumstances.

Example 2. Call option issued in connection with the performance of services. (i) E is a bona fide employee of S, a corporation. S issues to E a call option in connection with E's performance of services. At the time the call option is issued, it is not transferable and does not have a readily ascertainable fair market value. However, the call option becomes transferable before it is exercised by E.

(ii) While the option is not transferable, under paragraph (l)(4)(iii)(B)(*2*) of this section, it is not treated as a second class of stock, regardless of its strike price. When the option becomes transferable, that paragraph ceases to apply, and the general rule of paragraph (l)(4)(iii)(A) of this section applies. Accordingly, if the option is materially modified or is transferred to a person who is not an eligible shareholder under paragraph (b)(1) of this section, and on the date of such modification or transfer, the option is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock, the option is treated as a second class of stock.

(iii) If E left S's employment before the option became transferable, the exception provided by paragraph (l)(4)(iii)(B)(*2*) would continue to apply until the option became transferable.

(5) *Straight debt safe harbor*—(i) *In general.* Notwithstanding paragraph (l)(4) of this section, straight debt is not treated as a second class of stock. For purposes of section 1361(c)(5) and this section, the term straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which—

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

(ii) *Subordination.* The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt.

(iii) *Modification or transfer.* An obligation that originally qualifies as straight debt ceases to so qualify if the obligation—

(A) Is materially modified so that it no longer satisfies the definition of straight debt; or

(B) Is transferred to a third party who is not an eligible shareholder under paragraph (b)(1) of this section.

(iv) *Treatment of straight debt for other purposes.* An obligation of an S corporation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section is not treated as a second class of stock even if it is considered equity under general principles of Federal tax law. Such an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code. Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution to which section 1368 applies. However, if a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest. Such a recharacterization does not result in a second class of stock.

(v) *Treatment of C corporation debt upon conversion to S status.* If a C corporation has outstanding an obligation that satisfies the definition of straight debt in paragraph (l)(5)(i) of this section, but that is considered equity under general principles of Federal tax law, the obligation is not treated as a second class of stock for purposes of this section if the C corporation converts to S status. In addition, the conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to such an instrument.

(6) *Inadvertent terminations.* See section 1362(f) and the regulations thereunder for rules relating to inadvertent terminations in cases where the one class of stock requirement has been inadvertently breached.

(7) *Effective date.* Section 1.1361–1(l) generally applies to taxable years of a corporation beginning on or after May 28, 1992. However, §1.1361–1(l) does not apply to: an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date; a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, and not materially modified after that

date; or a call option or similar instrument issued before May 28, 1992, and not materially modified after that date. In addition, a corporation and its shareholders may apply this § 1.1361–1(l) to prior taxable years.

(m) *Electing small business trust (ESBT)*—(1) *Definition*—(i) *General rule.* An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in section 170(c)(2) through (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a potential current beneficiary; no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) *Qualified beneficiaries*—(A) *In general.* For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust.

(B) *Distributee trusts.* A distributee trust is the beneficiary of the ESBT only if the distributee trust is an organization described in section 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) *Powers of appointment.* A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) *Nonresident aliens.* A nonresident alien as defined in section 7701(b)(1)(B) is an eligible beneficiary of an ESBT. However, see paragraph (m)(4)(i) and (m)(5)(iii) of this section if the nonresident alien is a potential current beneficiary of the ESBT (which would result in an ineligible shareholder and termination of the S corporation election).

(iii) *Interests acquired by purchase.* A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

(iv) *Ineligible trusts.* An ESBT does not include—

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) *ESBT election*—(i) *In general.* The trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement. If any one of several trustees can legally bind the trust, only one trustee needs to sign the election statement. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns. This requirement applies only at the time of the initial ESBT election; if the ESBT later acquires stock in an S corporation which files its income tax return at a different service center, a new ESBT election is not required.

(ii) *Election statement.* The election statement must include—

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock. If the trust includes a power described in paragraph (m)(4)(vi)(B) of this section, then the election statement must include a statement that such a power is included in the instrument, but does not need to include the name, address, or taxpayer identification number of any particular charity or any other information regarding the power.

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) The date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and

(E) Representations signed by the trustee stating that—

(*1*) The trust meets the definitional requirements of section 1361(e)(1); and

(*2*) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1).

(iii) *Due date for ESBT election.* The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(iii) of this section for filing a qualified subchapter S trust (QSST) election.

(iv) *Election by a trust described in section 1361(c)(2)(A)(ii) or (iii).* A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii) may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue nevertheless to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) *No protective election.* A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make such a conditional ESBT election and it fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

(3) *Effect of ESBT election*—(i) *General rule.* If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

(ii) *Employer Identification Number.* An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) *Taxable year.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The termination of the ESBT election (including a termination caused by a conversion of the ESBT to a QSST) other than on the last day of the trust's taxable year also does not cause the trust's taxable year to close. In either case, the trust files one tax return for the taxable year.

(iv) *Allocation of S corporation items.* If, during the taxable year of an S corporation, a trust is an ESBT for part of the year and an eligible shareholder under section 1361(c)(2)(A)(i) through (iv) for the rest of the year, the S corporation items are allocated between the two types of trusts under section 1377(a). See §1.1377–1(a)(2)(iii).

(v) *Estimated taxes.* If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) *Potential current beneficiaries*—(i) *In general.* For purposes of determining whether a corporation is a small business corporation within the meaning of

section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is treated as a potential current beneficiary solely because that person holds any future interest in the trust.

(ii) *Grantor trusts.* If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) *Special rule for dispositions of stock.* Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

(iv) *Distributee trusts*—(A) *In general.* This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B) (ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) *Contingent distributions.* A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

(vi) *Currently exercisable powers of appointment and other powers*—(A) *Powers of appointment.* A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041–1(b) of this chapter and section 2514 and § 25.2514–1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a "general power of appointment" for transfer tax purposes as described in §§ 20.2041–1(c) and 25.2514–1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a ''power of appointment'' includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of ''power of appointment'' for purposes of any provision of the Internal Revenue Code or the regulations.

(B) *Powers to distribute to certain organizations not pursuant to powers of appointment.* If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041–1(b) and 25.2514–1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

(vii) *Number of shareholders.* Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for example, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, the husband and wife will be counted as one shareholder of the S corporation.

(viii) *Miscellaneous.* Payments made by an ESBT to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) *ESBT terminations*—(i) *Ceasing to meet ESBT requirements.* A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) *Disposition of S stock.* In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) *Potential current beneficiaries that are ineligible shareholders.* If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a nonresident alien becomes a potential current beneficiary of an ESBT.

Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, *see* the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

(6) *Revocation of ESBT election.* An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

(7) *Converting an ESBT to a QSST.* For a trust that seeks to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return. This QSST election must state at the top of the document ''ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361–1(m)'' and include all information otherwise required for a QSST election under §1.1361–1(j)(6). A separate QSST election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(8) *Examples.* The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *ESBT election with section 663(c) separate shares.* On January 1, 2003, *M* contributes S corporation stock to Trust for the benefit of *M*'s three children *A*, *B*, and *C*. Pursuant to section 663(c), each of Trust's separate shares for *A*, *B*, and *C* will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(ii) *ESBT acquires stock of an additional S corporation.* On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(iii) *Section 663(c) shares of ESBT convert to separate QSSTs.* Effective January 1, 2004, *A*, *B*, *C*, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.

Example 2. (i) *Invalid potential current beneficiary.* Effective January 1, 2005, Trust makes a valid ESBT election. On January 1, 2006, *A*, a nonresident alien, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within one year after January 1, 2006. As of January 1, 2006, *A* is the potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because *A* is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any corporation in which Trust holds stock terminates effective January 1, 2006. Relief may be available under section 1362(f).

(ii) *Invalid potential current beneficiary and disposition of S stock.* Assume the same facts as in *Example 2* (i) except that within one year after January 1, 2006, trustee of Trust disposes of all Trust's S corporation stock. *A* is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.

Example 3. Subpart E trust. *M* transfers stock in *X*, an S corporation, and other assets to Trust for the benefit of *B* and *B*'s siblings. *M* retains no powers or interest in Trust. Under section 678(a), *B* is treated as the owner of a portion of Trust that includes a portion of the *X* stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase, and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

Example 4. Subpart E trust continuing after grantor's death. On January 1, 2003, M transfers stock in *X*, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to *M* during *M*'s lifetime and to *M*'s children upon *M*'s death. During *M*'s life, *M* is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, M dies. Under applicable local law, Trust does not terminate on *M*'s death. Trust continues to be an ESBT after *M*'s death, and no additional ESBT election needs to be filed for Trust after *M*'s death.

Example 5. Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to *A* directly or to any trust created for the benefit of *A*. On January 1, 2003, *M* creates Trust-2 for the benefit of *A*. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. *A*, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because *A* is already counted as an S corporation shareholder because of *A*'s status as a potential current income beneficiary of Trust-1, *A* is not counted again by reason of *A*'s status as the deemed owner of Trust-2.

Example 6. Potential current beneficiaries and distributee trust not holding S corporation stock. (i) *Distributee trust that would itself qualify as an ESBT.* Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, *A*, *B*, *C*, *D*, and *E* are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(ii) *Distributee trust that would not qualify as an ESBT or a QSST.* Assume the same facts as in paragraph (i) of this *Example 6* except that *D* is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, *X*'s S corporation election terminates.

(iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust.* Assume the same facts as in paragraph (i) of this *Example 6* except that Trust-2 is a trust treated as owned by *A* under section 676 because *A* has the power to revoke Trust-2 at any time prior to *A*'s death. On January 1, 2003, *A* dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of *A*'s death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), *A*'s estate. Thus, *B* and *A*'s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

Example 7. Potential current beneficiaries and powers of appointment. *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of A's estate. The potential current beneficiaries of Trust for any period will be *A* and each person who receives a distribution from Trust pursuant to *A*'s exercise of *A*'s power of appointment during that period.

Example 8. Power to distribute to an unlimited class of charitable organizations not pursuant to a power of appointment. *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, each then-living descendant of M, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

Example 9. Power to distribute to a class of named charitable organizations not pursuant to a power of appointment. *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.

(9) *Effective date*. This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002. Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), *Example 2*, *Example 5*, *Example 7*, *Example 8*, and *Example 9* of this section are effective on *August 14, 2008*.

[T.D. 8419, 57 FR 22649, May 29, 1992; 57 FR 28613, June 26, 1992, as amended by T.D. 8600, 60 FR 37581, July 21, 1995; 60 FR 49976, Sept. 27, 1995; 60 FR 58234, Nov. 27, 1995; 61 FR 2869, Jan. 29, 1996; T.D. 8869, 65 FR 3849, Jan. 25, 2000; T.D. 8940, 66 FR 9929, 9957, Feb. 13, 2001; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9078, 68 FR 42252, July 17, 2003; T.D. 9422, 73 FR 47527, Aug. 14, 2008]

§ 1.1361–2 Definitions relating to S corporation subsidiaries.

(a) *In general*. The term *qualified subchapter S subsidiary* (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSub under § 1.1361–3.

(b) *Stock treated as held by S corporation*. For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section—

(1) Stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor*. Section 1.1361–1(l)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361–1(l)(5) if issued by the S corporation.

(d) *Examples*. The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of Y, a corporation for which a valid QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub under section 1361(b)(3)(B)(ii).

Example 2. Assume the same facts as in *Example 1*, except that Y is a business entity that is disregarded as an entity separate from its owner under § 301.7701–2(c)(2) of this chapter. X may elect to treat Z as a QSub.

Example 3. Assume the same facts as in *Example 1*, except that Y owns 50 percent of Z, and X owns the other 50 percent. X may elect to treat Z as a QSub.

Example 4. Assume the same facts as in *Example 1*, except that Y is a C corporation. Although Y is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for Y. Thus, X is not treated as holding the stock of Z. Consequently, X may not elect to treat Z as a QSub.

Example 5. Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361–1(l)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding stock. In addition, under § 1.1361–1(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361–1(l)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.

[T.D. 8869, 65 FR 3849, Jan. 25, 2000]

§ 1.1361–3 QSub election.

(a) *Time and manner of making election*—(1) *In general*. The corporation for which the QSub election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

(2) *Manner of making election*. Except as provided in section 1361(b)(3)(D) and

§ 1.1361–5(c) (five-year prohibition on re-election), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the IRS. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037. Unless the election form provides otherwise, the election must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable), and, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should be submitted to the service center where the S corporation filed its most recent return.

(3) *Time of making election.* A QSub election may be made by the S corporation parent at any time during the taxable year.

(4) *Effective date of election.* A QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term *month* found in § 1.1362–6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed.

(5) *Example.* The following example illustrates the application of paragraph (a)(4) of this section:

Example. X has been a calendar year S corporation engaged in a trade or business for several years. X acquires the stock of Y, a calendar year C corporation, on April 1, 2002. On August 10, 2002, X makes an election to treat Y as a QSub. Unless otherwise specified on the election form, the election will be effective as of August 10, 2002. If specified on the election form, the election may be effective on some other date that is not more than two months and 15 days prior to August 10, 2002, and not more than 12 months after August 10, 2002.

(6) *Extension of time for making a QSub election.* An extension of time to make a QSub election may be available under the procedures applicable under §§ 301.9100–1 and 301.9100–3 of this chapter.

(b) *Revocation of QSub election*—(1) *Manner of revoking QSub election.* An S corporation may revoke a QSub election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSub, if any. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation.* The revocation of a QSub election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

(3) *Revocation after termination.* A revocation may not be made after the occurrence of an event that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(4) *Revocation before QSub election effective.* For purposes of Section 1361(b)(3)(D) and § 1.1361–5(c) (five-year prohibition on re-election), a revocation effective on the first day the QSub election was to be effective will not be

treated as a termination of a QSub election.

[T.D. 8869, 65 FR 3850, Jan. 25, 2000]

§ 1.1361–4 Effect of QSub election.

(a) *Separate existence ignored*—(1) *In general.* Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), (a)(8), and (a)(9) of this section, for Federal tax purposes—

(i) A corporation that is a QSub shall not be treated as a separate corporation; and

(ii) All assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

(2) *Liquidation of subsidiary*—(i) *In general.* If an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the transfer of assets to the subsidiary and the deemed liquidation are disregarded, and the corporation will be deemed to be a QSub from its inception.

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(2)(i) of this section:

Example 1. Corporation X acquires all of the outstanding stock of solvent corporation Y from an unrelated individual for cash and short-term notes. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. Because X acquired all of the stock of Y in a qualified stock purchase within the meaning of section 338(d)(3), the liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337.

Example 2. Corporation X, pursuant to a plan, acquires all of the outstanding stock of corporation Y from the shareholders of Y solely in exchange for 10 percent of the voting stock of X. Prior to the transaction, Y and its shareholders are unrelated to X. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. The transaction is a reorganization described in section 368(a)(1)(C), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied.

Example 3. After the expiration of the transition period provided in paragraph (a)(5)(i) of this section, individual A, pursuant to a plan, contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction is a reorganization under section 368(a)(1)(D), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied. If the sum of the amount of liabilities of Y treated as assumed by X exceeds the total of the adjusted basis of the property of Y, then section 357(c) applies and such excess is considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(iii) *Adoption of plan of liquidation.* For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the QSub election is adopted on an earlier date, the making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (a)(2)(i) of this section.

(iv) *Example.* The following example illustrates the application of paragraph (a)(2)(iii) of this section:

Example. Corporation X owns 75 percent of a solvent corporation Y, and individual A owns the remaining 25 percent of Y. As part of a plan to make a QSub election for Y, X causes Y to redeem A's 25 percent interest on June 1 for cash and makes a QSub election for Y effective on June 3. The making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation. The deemed liquidation satisfies the requirements of section 332.

(v) *Stock ownership requirements of section 332.* The deemed exercise of an option under § 1.1504–4 and any instruments, obligations, or arrangements that are not considered stock under

§ 1.1361–2(b)(2) are disregarded in determining if the stock ownership requirements of section 332(b) are met with respect to the deemed liquidation provided in paragraph (a)(2)(i) of this section.

(3) *Treatment of banks*—(i) *In general.* If an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub under paragraph (a)(2) of this section had not occurred (except as other published guidance may apply section 265(b) and section 291(a)(3) and (e)(1)(B) not only to the bank parent or bank subsidiary but also to any QSub deemed to have liquidated under paragraph (a)(2) of this section). For any QSub that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSub, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. For purposes of this paragraph (a)(3)(i), the term bank has the same meaning as in section 581.

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(3):

Example 1. X, an S corporation, is a bank as defined in section 581. X owns 100 percent of Y and Z, corporations for which valid QSub elections are in effect. Y is a bank as defined in section 581, and Z is not a financial institution. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to X and Y and do not apply to Z. Thus, for example, section 265(b), which provides special rules for interest expense deductions of banks, applies separately to X and Y. That is, X and Y each must make a separate determination under section 265(b) of interest expense allocable to tax-exempt interest, and no deduction is allowed for that interest expense. Section 265(b) does not apply to Z except as published guidance may provide otherwise.

Example 2. X, an S corporation, is a bank holding company and thus is not a bank as defined in section 581. X owns 100 percent of Y, a corporation for which a valid QSub election is in effect. Y is a bank as defined in section 581. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply to Y and do not apply to X. However, all of Y's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as those of X. Thus, for example, section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Y. However, any gain or loss on such a transaction by Y that is considered ordinary income or ordinary loss pursuant to section 582(c) is treated as ordinary income or ordinary loss of X.

(iii) *Effective date.* This paragraph (a)(3) applies to taxable years beginning after December 31, 1996.

(4) *Treatment of stock of QSub.* Except for purposes of section 1361(b)(3)(B)(i) and § 1.1361–2(a)(1), the stock of a QSub shall be disregarded for all Federal tax purposes.

(5) *Transitional relief*—(i) *General rule.* If an S corporation and another corporation (the related corporation) are persons specified in section 267(b) prior to an acquisition by the S corporation of some or all of the stock of the related corporation followed by a QSub election for the related corporation, the step transaction doctrine will not apply to determine the tax consequences of the acquisition. This paragraph (a)(5) shall apply to QSub elections effective before January 1, 2001.

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(5):

Example 1. Individual A owns 100 percent of the stock of X, an S corporation. X owns 79 percent of the stock of Y, a solvent corporation, and A owns the remaining 21 percent. On May 4, 1998, A contributes its Y stock to X in exchange for X stock. X makes a QSub election with respect to Y effective immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock qualifies under section 351, and no gain or loss is recognized by A, X, or Y.

Example 2. Individual A owns 100 percent of the stock of two solvent S corporations, X and Y. On May 4, 1998, A contributes the stock of Y to X. X makes a QSub election with respect to Y immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections

332 and 337. The contribution by A of the Y stock to X qualifies under section 351, and no gain or loss is recognized by A, X, or Y. Y is not treated as a C corporation for any period solely because of the transfer of its stock to X, an ineligible shareholder. Compare *Example 3* of §1.1361–4(a)(2)(ii).

(6) *Treatment of certain QSubs*—(i) *In general.* A QSub, even though it is generally not treated as a corporation separate from the S corporation, is treated as a separate corporation for purposes of:

(A) Federal tax liabilities of the QSub with respect to any taxable period for which the QSub was treated as a separate corporation.

(B) Federal tax liabilities of any other entity for which the QSub is liable.

(C) Refunds or credits of Federal tax.

(ii) *Examples.* The following examples illustrate the application of paragraph (a)(6)(i) of this section:

Example 1. X has owned all of the outstanding stock of Y, a domestic corporation that reports its taxes on a calendar year basis, since 2001. X and Y do not report their taxes on a consolidated basis. For 2003, X makes a timely S election and simultaneously makes a QSub election for Y. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for Y's 2001 taxable year. Because Y was treated as a separate corporation for its 2001 taxable year, Y is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in *Example 1,* except that in 2004, the IRS determines that Y miscalculated and underreported its income tax liability for 2001. Because Y was treated as a separate corporation for its 2001 taxable year, the deficiency for Y's 2001 taxable year may be assessed against Y and, in the event that Y fails to pay the liability after notice and demand, a general tax lien will arise against all of Y's property and rights to property.

Example 3. X is a QSub of Y. In 2001, Z, a domestic corporation that reports its taxes on a calendar year basis, merges into X in a state law merger. Z was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, X is the successor to Z and is liable for all of Z's debts. In 2003, the IRS seeks to extend the period of limitations on assessment for Z's 2000 taxable year. Because X is the successor to Z and is liable for Z's 2000 taxes that remain unpaid, X is the proper party to execute the consent to extend the period of limitations on assessment.

(iii) *Effective date.* This paragraph (a)(6) applies on or after April 1, 2004.

(7) *Treatment of QSubs for purposes of employment taxes*—(i) *In general.* A QSub is treated as a separate corporation for purposes of Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(ii) *Effective/applicability date.* This paragraph (a)(7) applies with respect to wages paid on or after January 1, 2009.

(8) *Treatment of QSubs for purposes of certain excise taxes*—(i) *In general.* A QSub is treated as a separate corporation for purposes of—

(A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(B) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;

(C) Registration under sections 4101, 4222, and 4412;

(D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under section 6426 or 6427; and

(E) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.

(ii) *Effective/applicability date.* (A) Except as provided in this paragraph (a)(8)(ii), paragraph (a)(8) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

(B) References to Chapter 49 in paragraph (a)(8) of this section apply to taxes imposed on amounts paid on or after July 1, 2012.

(C) Paragraph (a)(8)(i)(E) of this section applies for periods after December 31, 2014.

(9) *Information returns*—(i) *In general.* Except to the extent provided by the Secretary or Commissioner in guidance (including forms or instructions), paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.

(ii) *Effective/applicability date*. This paragraph (a)(9) is effective on *August 14, 2008*.

(b) *Timing of the liquidation*—(1) *In general*. Except as otherwise provided in paragraph (b)(3) or (4) of this section, the liquidation described in paragraph (a)(2) of this section occurs at the close of the day before the QSub election is effective. Thus, for example, if a C corporation elects to be treated as an S corporation and makes a QSub election (effective the same date as the S election) with respect to a subsidiary, the liquidation occurs immediately before the S election becomes effective, while the S electing parent is still a C corporation.

(2) *Application to elections in tiered situations*. 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. 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 lowest tier entity and proceed successively upward until all of the liquidations under paragraph (a)(2) of this section have occurred. For example, S, an S corporation, owns 100 percent of C, the common parent of an affiliated group of corporations that includes X and Y. C owns all of the stock of X and X owns all of the stock of Y. S elects under §1.1361–3 to treat C, X and Y as QSubs effective on the same date. If no order is specified for the elections, the following liquidations are deemed to occur as a result of the elections, with each successive liquidation occuring on the same day immediately after the preceding liquidation: Y is treated as liquidating into X, then X is treated as liquidating into C, and finally C is treated as liquidating into S.

(3) *Acquisitions*. (i) *In general*. If an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSub election is effective, the liquidation described in paragraph (a)(2) of this section occurs immediately after the time at which the S corporation first owns 100 percent of the stock.

(ii) *Special rules for acquired S corporations*. Except as provided in paragraph (b)(4) of this section, if a corporation (Y) for which an election under section 1362(a) was in effect is acquired, and a QSub election is made effective on the day Y is acquired, Y is deemed to liquidate into the S corporation at the beginning of the day the termination of its S election is effective. As a result, if corporation X acquires Y, an S corporation, and makes an S election for itself and a QSub election for Y effective on the day of acquisition, Y liquidates into X at the beginning of the day when X's S election is effective, and there is no period between the termination of Y's S election and the deemed liquidation of Y during which Y is a C corporation. Y's taxable year ends for all Federal income tax purposes at the close of the preceding day. Furthermore, if Y owns Z, a corporation for which a QSub election was in effect prior to the acquisition of Y by X, and X makes QSub elections for Y and Z, effective on the day of acquisition, the transfer of assets to Z and the deemed liquidation of Z are disregarded. See §§1.1361–4(a)(2) and 1.1361–5(b)(1)(i).

(4) *Coordination with section 338 election*. An S corporation that makes a qualified stock purchase of a target may make an election under section 338 with respect to the acquisition if it meets the requirements for the election, and may make a QSub election with respect to the target. If an S corporation makes an election under section 338 with respect to a subsidiary acquired in a qualified stock purchase, a QSub election made with respect to that subsidiary is not effective before the day after the acquisition date (within the meaning of section 338(h)(2)). If the QSub election is effective on the day after the acquisition date, the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new target corporation under section 338. If an S corporation makes an election under section 338 (without a section 338(h)(10) election) with respect to a target, the target must file a final return as a C corporation reflecting the deemed sale. *See §1.338–10(a)*. If the target was an S corporation on the day before the acquisition date, the final return as a C corporation must reflect the activities of the

target for the acquisition date, including the deemed sale. *See §1.338–10(a)(3)*.

(c) *Carryover of disallowed losses and deductions*. If an S corporation (S1) acquires the stock of another S corporation (S2), and S1 makes a QSub election with respect to S2 effective on the day of the acquisition, see §1.1366–2(c)(1) for provisions relating to the carryover of losses and deductions with respect to a former shareholder of S2 that may be available to that shareholder as a shareholder of S1.

(d) *Examples*. The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. On June 2, 2002, X makes a valid QSub election for Y, effective June 2, 2002. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of the day on June 1, 2002, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Y's taxable year and separate existence for Federal tax purposes end at the close of June 1, 2002.

Example 2. X, a C corporation, owns 100 percent of the stock of Y, another C corporation. On December 31, 2002, X makes an election under section 1362 to be treated as an S corporation and a valid QSub election for Y, both effective January 1, 2003. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of December 31, 2002, the day before the QSub election is effective. The QSub election for Y is effective on the same day that X's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when X is still a C corporation. Y's taxable year ends at the close of December 31, 2002. See §1.381(b)–1.

Example 3. On June 1, 2002, X, an S corporation, acquires 100 percent of the stock of Y, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under section 338. X immediately makes a QSub election for Y effective June 2, 2002, and also makes a joint election under section 338(h)(10) with the shareholder of Y. Under section 338(a) and §1.338(h)(10)–1(d)(3), Y is treated as having sold all of its assets at the close of the acquisition date, June 1, 2002. Y is treated as a new corporation which purchased all of those assets as of the beginning of June 2, 2002, the day after the acquisition date. Section 338(a)(2). The QSub election is effective on June 2, 2002, and the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new corporation.

Example 4. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. On May 12, 2002, a date on which the QSub election is in effect, X issues Y a $10,000 note under state law that matures in ten years with a market rate of interest. Y is not treated as a separate corporation, and X's issuance of the note to Y on May 12, 2002, is disregarded for Federal tax purposes.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. At a time when Y is indebted to X in an amount that exceeds the fair market value of Y's assets, X makes a QSub election effective on the date it is filed with respect to Y. The liquidation described in paragraph (a)(2) of this section does not qualify under sections 332 and 337 and, thus, Y recognizes gain or loss on the assets distributed, subject to the limitations of section 267.

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§ 1.1361–5 Termination of QSub election.

(a) In *general*—(1) *Effective date*. The termination of a QSub election is effective—

(i) On the effective date contained in the revocation statement if a QSub election is revoked under §1.1361–3(b);

(ii) At the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under §1.1362–2; or

(iii) At the close of the day on which an event (other than an event described in paragraph (a)(1)(ii) of this section) occurs that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(2) *Information to be provided upon termination of QSub election by failure to qualify as a QSub*. If a QSub election terminates because an event renders the subsidiary ineligible for QSub status, the S corporation must attach to its return for the taxable year in which

the termination occurs a notification that a QSub election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSub.

(3) *QSub joins a consolidated group.* If a QSub election terminates because the S corporation becomes a member of a consolidated group (and no election under section 338(g) is made) the principles of §1.1502–76(b)(1)(ii)(A)(2) (relating to a special rule for S corporations that join a consolidated group) apply to any QSub of the S corporation that also becomes a member of the consolidated group at the same time as the S corporation. See *Example 4* of paragraph (a)(4) of this section.

(4) *Examples. The following examples illustrate the application of this paragraph (a):*

Example 1. Termination because parent's S election terminates. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y for 2001. Effective on January 1, 2002, X revokes its S election. Because X is no longer an S corporation, Y no longer qualifies as a QSub at the close of December 31, 2001.

Example 2. Termination due to transfer of QSub stock. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y. On December 10, 2002, X sells one share of Y stock to A, an individual. Because X no longer owns 100 percent of the stock of Y, Y no longer qualifies as a QSub. Accordingly, the QSub election made with respect to Y terminates at the close of December 10, 2002.

Example 3. No termination on stock transfer between QSub and parent. X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. QSub elections are in effect with respect to both Y and Z. Y transfers all of its Z stock to X. Because X is treated as owning the stock of Z both before and after the transfer of stock solely for purposes of determining whether the requirements of section 1361(b)(3)(B)(i) and §1.1361–2(a)(1) have been satisfied, the transfer of Z stock does not terminate Z's QSub election. Because the stock of Z is disregarded for all other Federal tax purposes, no gain is recognized under section 311.

Example 4. Termination due to acquisition of S parent by a consolidated group. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. Z, the common parent of a consolidated group of corporations, acquires 80 percent of the stock of X on June 1, 2002. Z does not make an election under section 338(g) with respect to the purchase of X stock. X's S election terminates as of the close of the preceding day, May 31, 2002. Y's QSub election also terminates at the close of May 31, 2002. Under §1.1502–76(b)(1)(ii)(A)(2) and paragraph (a)(3) of this section, X and Y become members of Z's consolidated group of corporations as of the beginning of the day June 1, 2002.

Example 5. Termination due to acquisition of QSub by a consolidated group. The facts are the same as in Example 4, except that Z acquires 80 percent of the stock of Y (instead of X) on June 1, 2002. In this case, Y's QSub election terminates as of the close of June 1, 2002, and, under §1.1502–76(b)(1)(ii)(A)(1), Y becomes a member of the consolidated group at that time.

(b) *Effect of termination of QSub election*—(1) *Formation of new corporation*—(i) *In general.* If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under §1.1361–2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

(ii) *Termination for tiered QSubs.* If QSub elections terminate for tiered QSubs on the same day, the formation of any higher tier subsidiary precedes the formation of its lower tier subsidiary. See Example 6 in paragraph (b)(3) of this section.

(2) *Carryover of disallowed losses and deductions.* If a QSub terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in a transaction to which section 368(a)(1)(D) applies by reason of section 355 (or so much of section 356 as relates to section 355), see §1.1366–2(c)(2) for provisions relating to the carryover of disallowed losses and deductions that may be available.

(3) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

Example 2. (i) X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. As part of a plan to sell a portion of Y, X causes Y to merge into T, a limited liability company wholly owned by X that is disregarded as an entity separate from its owner for Federal tax purposes. X then sells 21 percent of T to Z, an unrelated corporation, for cash. Following the sale, no entity classification election is made under § 301.7701–3(c) of this chapter to treat the limited liability company as an association for Federal tax purposes.

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation (Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

(iii) Under section 1001, X recognizes gain or loss from the deemed sale of the 21 percent interest in each asset of the limited liability company to Z. Under section 721(a), no gain or loss is recognized by X and Z as a result of the deemed contribution of their respective interests in the assets to the partnership in exchange for ownership interests in the partnership.

Example 3. Assume the same facts as in *Example 1,* except that, instead of purchasing Y stock, Z contributes to Y an operating asset in exchange for 21 percent of the Y stock. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination. Because X and Z are co-transferors that control the transferee immediately after the transfer, the transaction qualifies under section 351.

Example 4. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X distributes all of the Y stock pro rata to its shareholders, and the distribution terminates the QSub election. The transaction can qualify as a distribution to which sections 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

Example 6. (i) X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. Y and Z are corporations for which QSub elections are in effect. X subsequently revokes the QSub elections and the effective date specified on each revocation statement is June 26, 2002, a date that is less than 12 months after the date on which the revocation statements are filed.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from Y in exchange for the stock of Z.

Example 7. (i) The facts are the same as in Example 6, except that, prior to June 26, 2002 (the effective date of the revocations), Y distributes the Z stock to X under state law.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is also treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Z.

Example 8. Merger of parent into QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X merges into Y under state law, causing the QSub election for Y to terminate, and Y survives the merger. The formation of the new corporation, Y, and the merger of X into Y can qualify as a reorganization described in section 368(a)(1)(F) if the transaction otherwise satisfies the requirements of that section.

Example 9. Transfer of 100 percent of QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. Z, an unrelated C corporation, acquires 100 percent of the stock of Y. The deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of Y to Z, followed by Z's transfer of these assets to the capital of Y in exchange for Y stock. Furthermore, if Z is an S corporation and makes a QSub election for Y effective as of the acquisition, Z's transfer of the assets of Y in exchange for Y stock, followed by the immediate liquidation of Y as a consequence of the QSub election are disregarded for Federal income tax purposes.

(c) *Election after QSub termination*—(1) *In general.* Absent the Commissioner's consent, and except as provided in paragraph (c)(2) of this section, a corporation whose QSub election has terminated under paragraph (a) of this section (or a successor corporation as defined in§ 1.1362–5(b)) may not make an S election under section 1362 or have a QSub election under section 1361(b)(3)(B)(ii) made with respect to it for five taxable years (as described in section 1361(b)(3)(D)). The Commissioner may permit an S election by the corporation or a new QSub election with respect to the corporation before the five-year period expires. The corporation requesting consent to make the election has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election.

(2) *Exception.* In the case of S and QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSub election made with respect to it before the expiration of the five-year period described in section 1361(b)(3)(D) and paragraph (c)(1) of this section, provided that—

(i) Immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and

(ii) The relevant election is made effective immediately following the termination of the QSub election.

(3) *Examples.* The following examples illustrate the application of this paragraph (c):

Example 1. Termination upon distribution of QSub stock to shareholders of parent. X, an S corporation, owns Y, a QSub. X distributes all of its Y stock to X's shareholders. The distribution terminates the QSub election because Y no longer satisfies the requirements of a QSub. Assuming Y is otherwise eligible to be treated as an S corporation, Y's shareholders may elect to treat Y as an S corporation effective on the date of the stock distribution without requesting the Commissioner's consent.

Example 2. Sale of 100 percent of QSub stock. X, an S corporation, owns Y, a QSub. X sells 100 percent of the stock of Y to Z, an unrelated S corporation. Z may elect to treat Y as a QSub effective on the date of purchase without requesting the Commissioner's consent.

[T.D. 8869, 65 FR 3852, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000, as amended by T.D. 8869, 67 FR 65313, Oct. 24, 2002]

§ 1.1361–6 Effective date.

Except as provided in §§ 1.1361–4(a)(3)(iii), 1.1361–4(a)(5)(i), 1.1361–4(a)(6)(iii), 1.1361–4(a)(7)(ii), 1.1361–4(a)(8)(ii), 1.1361–4(a)(9), and 1.1361–5(c)(2), the provisions of §§ 1.1361–2 through 1.1361–5 apply to taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

[T.D. 8869, 65 FR 3854, Jan. 25, 2000, as amended by T.D. 9356, 72 FR 45893, Aug. 16, 2007; T.D. 9422, 73 FR 47530, Aug. 14, 2008]

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(c) Allocating distributions to active or passive earnings and profits.
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(4) Special rules for consolidated groups.
(d) Examples.
(e) Effective date.

[T.D. 8449, 57 FR 55448, Nov. 25, 1992; 58 FR 3330, Jan. 8, 1993, as amended by T.D. 8869, 65 FR 3854, Jan. 25, 2000; T.D. 9422, 73 FR 47530, Aug. 14, 2008]

§ 1.1362–1 Election to be an S corporation.

(a) *In general.* Except as provided in § 1.1362–5, a small business corporation as defined in section 1361 may elect to be an S corporation under section 1362(a). An election may be made only with the consent of all of the shareholders of the corporation at the time of the election. See § 1.1362–6(a) for rules concerning the time and manner of making this election.

(b) *Years for which election is effective.* An election under section 1362(a) is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992]

§ 1.1362–2 Termination of election.

(a) *Termination by revocation*—(1) *In general.* An election made under section 1362(a) is terminated if the corporation revokes the election for any taxable year of the corporation for which the election is effective, including the first taxable year. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. See § 1.1362–6(a) for rules concerning the time and manner of revoking an election made under section 1362(a).

(2) *When effective*—(i) *In general.* Except as provided in paragraph (a)(2)(ii) of this section, a revocation made during the taxable year and before the 16th day of the third month of the taxable year is effective on the first day of the taxable year and a revocation made after the 15th day of the third month of the taxable year is effective for the following taxable year. If a corporation makes an election to be an S corporation that is to be effective beginning with the next taxable year and revokes its election on or before the first day of the next taxable year, the corporation is deemed to have revoked its election on the first day of the next taxable year.

(ii) *Revocations specifying a prospective revocation date.* If a corporation specifies a date for revocation and the date is expressed in terms of a stated day, month, and year that is on or after the date the revocation is filed, the revocation is effective on and after the date so specified.

(3) *Effect on taxable year of corporation.* In the case of a corporation that revokes its election to be an S corporation effective on the first day of the first taxable year for which its election is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(4) *Rescission of a revocation.* A corporation may rescind a revocation made under paragraph (a)(2) of this section at any time before the revocation becomes effective. A rescission may be made only with the consent of each person who consented to the revocation and by each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made. See §1.1362–6(a) for rules concerning the time and manner of rescinding a revocation.

(b) *Termination by reason of corporation ceasing to be a small business corporation*—(1) *In general.* If a corporation ceases to be a small business corporation, as defined in section 1361(b), at any time on or after the first day of the first taxable year for which its election under section 1362(a) is effective, the election terminates. In the event of a termination under this paragraph (b)(1), the corporation should attach to its return for the taxable year in which the termination occurs a notification that a termination has occurred and the date of the termination.

(2) *When effective.* If an election terminates because of a specific event that causes the corporation to fail to meet the definition of a small business corporation, the termination is effective as of the date on which the event occurs. If a corporation makes an election to be an S corporation that is effective beginning with the following taxable year and is not a small business corporation on the first day of that following taxable year, the election is treated as having terminated on that first day. If a corporation is a small business corporation on the first day of the taxable year for which its election is effective, its election does not terminate even if the corporation was not a small business corporation during all or part of the period beginning after the date the election was made and ending before the first day of the taxable year for which the election is effective.

(3) *Effect on taxable year of corporation.* In the case of a corporation that fails to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(c) *Termination by reason of excess passive investment income*—(1) *In general.* A corporation's election under section 1362(a) terminates if the corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years and, for each of those taxable years, has passive investment income in excess of 25 percent of gross receipts. See section 1375 for the tax imposed on excess passive investment income.

(2) *When effective.* A termination under this paragraph (c) is effective on the first day of the first taxable year beginning after the third consecutive year in which the S corporation had excess passive investment income.

(3) *Subchapter C earnings and profits.* For purposes of this paragraph (c), *subchapter C earnings and profits* of a corporation are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under section 1362(a) (or under section 1372 of prior law) was not in effect. The subchapter C earnings and profits of an S corporation are modified as required by section 1371(c).

(4) *Gross receipts*—(i) *In general.* For purposes of this paragraph (c), *gross receipts* generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions.

(ii) *Special rules for sales of capital assets, stock and securities*—(A) *Sales of capital assets.* For purposes of this paragraph (c), gross receipts from the sales or exchanges of capital assets (as defined in section 1221), other than stock and securities, are taken into account only to the extent of capital gain net income (as defined in section 1222).

(B) *Sales of stock or securities*—(*1*) *In general.* For purposes of this paragraph (c), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. In addition, for purposes of computing gross receipts from sales or exchanges of stock or securities, losses do not offset gains.

(*2*) *Treatment of certain liquidations.* Gross receipts from the sales or exchanges of stock or securities do not include amounts described in section 1362(d)(3)(D)(iv), relating to the treatment of certain liquidations. For purposes of section 1362(d)(3)(D)(iv), stock of the liquidating corporation owned by an S corporation shareholder is not treated as owned by the S corporation.

(*3*) *Definition of stock or securities.* For purposes of this paragraph (c), *stock or securities* includes shares or certificates of stock, stock rights or warrants, or an interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation under section 7701); an interest as a limited partner in a partnership; certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease; collateral trust certificates; voting trust certificates; bonds; debentures; certificates of indebtedness; notes; car trust certificates; bills of exchange; or obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(*4*) *General partner interests*—(*i*) *In general.* Except as provided in paragraph (c)(4)(ii)(B)(*4*)(*ii*) of this section, if an S corporation disposes of a general partner interest, the gain on the disposition is treated as gain from the sale of stock or securities to the extent of the amount the S corporation would have received as a distributive share of gain from the sale of stock or securities held by the partnership if all of the stock and securities held by the partnership had been sold by the partnership at fair market value at the time the S corporation disposes of the general partner interest. In applying this rule, the S corporation's distributive share of gain from the sale of stock or securities held by the partnership is not reduced to reflect any loss that would be recognized from the sale of stock or securities held by the partnership. In the case of tiered partnerships, the rules of this section apply by looking through each tier.

(*ii*) *Exception.* An S corporation that disposes of a general partner interest may treat the disposition, for purposes of this paragraph (c), in the same manner as the disposition of an interest as a limited partner.

(iii) *Other exclusions from gross receipts.* For purposes of this paragraph (c), gross receipts do not include—

(A) Amounts received in nontaxable sales or exchanges except to the extent that gain is recognized by the corporation on the sale or exchange; or

(B) Amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(5) *Passive investment income*—(i) *In general.* In general, *passive investment income* means gross receipts (as defined in paragraph (c)(4) of this section) derived from royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock or securities.

(ii) *Definitions.* For purposes of this paragraph (c)(5), the following definitions apply:

(A) *Royalties*—(*1*) *In general. Royalties* means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income.

(*2*) *Royalties derived in the ordinary course of a trade or business. Royalties* does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation—

(*i*) Created the property; or

(*ii*) Performed significant services or incurred substantial costs with respect to the development or marketing of the property.

(*3*) *Copyright, mineral, oil and gas, and active business computer software royalties. Royalties* does not include copyright royalties, nor mineral, oil and gas royalties if the income from those royalties would not be treated as personal holding company income under sections 543 (a)(3) and (a)(4) if the corporation were a C corporation; amounts received upon disposal of timber, coal, or domestic iron ore with respect to which the special rules of sections 631 (b) and (c) apply; and active business computer software royalties as defined under section 543(d) (without regard to paragraph (d)(5) of section 543).

(B) *Rents*—(*1*) *In general. Rents* means amounts received for the use of, or right to use, property (whether real or personal) of the corporation.

(*2*) *Rents derived in the active trade or business of renting property. Rents* does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

(*3*) *Produced film rents. Rents* does not include produced film rents as defined under section 543(a)(5).

(*4*) *Income from leasing self-produced tangible property. Rents* does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

(C) *Dividends. Dividends* includes dividends as defined in section 316, amounts to be included in gross income under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in section 565. See paragraphs (c)(5)(iii) (B) and (C) of this section for special rules for the treatment of certain dividends and certain payments to a patron of a cooperative. See §1.1362–8 for special rules regarding the treatment of dividends received by an S corporation from a C corporation in which the S corporation holds stock meeting the requirements of section 1504(a)(2).

(D) *Interest*—(*1*) *In general. Interest* means any amount received for the use of money (including tax-exempt interest and amounts treated as interest under section 483, 1272, 1274, or 7872). See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of interest derived in certain businesses.

(*2*) *Interest on obligations acquired in the ordinary course of a trade or business. Interest* does not include interest on any obligation acquired from the sale of property described in section 1221(1) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services.

(E) *Annuities. Annuities* means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includible in gross income under section 72.

(F) *Gross receipts from the sale of stock or securities.* Gross receipts from the sales or exchanges of stock or securities, as described in paragraph (c)(4)(ii)(B) of this section, are passive investment income to the extent of gains therefrom. See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of gains derived in certain businesses.

(G) *Identified income. Passive investment income* does not include income identified by the Commissioner by regulations, revenue ruling, or revenue procedure as income derived in the ordinary course of a trade or business for purposes of this section.

(iii) *Special rules.* For purposes of this paragraph (c)(5), the following special rules apply:

(A) *Options or commodities dealers.* In the case of an options dealer or commodities dealer, *passive investment income* does not include any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to the contract. *Options dealer, commodities dealer,* and *section 1256 contract* have the same meaning as in section 1362(d)(3)(E)(ii).

(B) *Treatment of certain lending, financing and other business*—(*1*) *In general. Passive investment income* does not include gross receipts that are directly derived in the ordinary course of a trade or business of—

(*i*) Lending or financing;

(*ii*) Dealing in property;

(*iii*) Purchasing or discounting accounts receivable, notes, or installment obligations; or

(*iv*) Servicing mortgages.

(*2*) *Directly derived.* For purposes of this paragraph (c)(5)(iii)(B), gross receipts directly derived in the ordinary course of business includes gain (as well as interest income) with respect to loans originated in a lending business, or interest income (as well as gain) from debt obligations of a dealer in such obligations. However, interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business. Similarly, a dealer's income or gain from an item of property is not directly derived in the ordinary course of its trade or business if the dealer held the property for investment at any time before the income or gain is recognized.

(C) *Payment to a patron of a cooperative. Passive investment income* does not include amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2) (A) or (C) of section 1381(a)) by reason of any payment or allocation to the patron based on patronage occurring in the case of a trade or business of the patron.

(6) *Examples.* The principles of paragraphs (c)(4) and (c)(5) of this section are illustrated by the following examples. Unless otherwise provided in an example, *S* is an S corporation with subchapter C earnings and profits, and *S*'s gross receipts from operations are gross receipts not derived from royalties, rents, dividends, interest, annuities, or gains from the sales or exchanges of stock or securities. *S* is a calendar year taxpayer and its first taxable year as an S corporation is 1993.

Example 1. Sales of capital assets, stock and securities. (i) *S* uses an accrual method of accounting and sells:

(1) A depreciable asset, held for more than 6 months, which is used in the corporation's business;

(2) A capital asset (other than stock or securities) for a gain;

(3) A capital asset (other than stock or securities) for a loss; and

(4) Securities.

S receives payment for each asset partly in money and partly in the form of a note payable at a future time, and elects not to report the sales on the installment method.

(ii) The amount of money and the face amount (or issue price if different) of the note received for the business asset are considered gross receipts in the taxable year of sale and are not reduced by the adjusted basis of the property, costs of sale, or any other amount. With respect to the sales of the capital assets, gross receipts include the cash down payment and face amount (or issue price if different) of any notes, but only to the extent of *S*'s capital gain net income. In the case of the sale of the securities, gross receipts include the cash down payment and face amount (or issue price if different) of the notes, but only to the extent of gain on the sale. In determining gross receipts from sales of securities, losses are not netted against gains.

Example 2. Long-term contract reported on percentage-of-completion method. S has a long-term contract as defined in §1.460–1(b)(1) with respect to which it reports income according to the percentage-of-completion method as described in §1.460–4(b). The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year is included in *S*'s gross receipts for the year.

Example 3. Income reported on installment sale method. For its 1993 taxable year, S sells personal property on the installment plan and elects to report its taxable income from the sale of the property (other than property qualifying as a capital asset or stock or securities) on the installment method in accordance with section 453. The installment payment actually received in a given taxable year of S is included in gross receipts for the year.

Example 4. Partnership interests. In 1993, S and two of its shareholders contribute cash to form a general partnership, PRS. S receives a 50 percent interest in the capital and profits of PRS. S formed PRS to indirectly invest in marketable stocks and securities. The only assets of PRS are the stock and securities, and certain real and tangible personal property. In 1994, S needs cash in its business and sells its partnership interest at a gain rather than having PRS sell the marketable stock or securities that have appreciated. Under paragraph (c)(4)(ii)(B)(*4*) of this section, the gain on S's disposition of its interest is PRS is treated as gain from the sale or exchange of stock or securities to the extent of the amount the distributive share of gain S would have received from the sale of stock or securities held by PRS if PRS had sold all of its stock or securities at fair market value at the time S disposed of its interest in PRS.

Example 5. Royalties derived in ordinary course of trade or business. (i) In 1993, S has gross receipts of $75,000. Of this amount, $5,000 is from royalty payments with respect to Trademark A, $8,000 is from royalty payments with respect to Trademark B, and $62,000 is gross receipts from operations. S created Trademark A, but S did not create Trademark B or perform significant services or incur substantial costs with respect to the development or marketing of Trademark B.

(ii) Because S created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of S's business and are not included within the definition of *royalties* for purposes of determining S's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of *royalties* for purposes of determining S's passive investment income. See paragraph (c)(5)(ii)(A) of this section. S's passive investment income for the year is $8,000, and S's passive investment income percentage for the taxable year is 10.67% ($8,000/$75,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 6. Dividends; gain on sale of stock derived in the ordinary course of trade or business. (i) In 1993, S receives dividends of $10,000 on stock of corporations P and O, recognizes a gain of $25,000 on sale of the P stock, and recognizes a loss of $12,000 on sale of the O stock. S held the P and O stock for investment, rather than for sale in the ordinary course of a trade or business. S has gross receipts from operations and from gain on the sale of stock in the ordinary course of its trade or business of $110,000.

(ii) S's gross receipts are calculated as follows:

$110,000	Gross receipts from operations and from gain on the sale of stock in the ordinary course of a trade or business
10,000	Gross dividend receipts
25,000	Gain on sale of P stock (Loss on O stock not taken into account
145,000	Total gross receipts

(iii) S's passive investment income is determined as follows:

$10,000	Gross dividend receipts
25,000	Gain on sale of P stock (Loss on O stock not taken into account
35,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 24.1% ($35,000/$145,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 7. Interest on accounts receivable; netting of gain on sale of real property investments. (i) In 1993, S receives $6,000 of interest on accounts receivable arising from S's sales of inventory property. S also received dividends with respect to stock held for investment of $1,500. In addition, *S* sells two parcels of real property (Property J and Property K) that S had purchased and held for investment. S sells Property J, in which S has a basis of $5,000, for $10,000 (a gain of $5,000). S sells Property K, in which S has a basis of $12,000, for $9,000 (a loss of $3,000). S has gross receipts from operations of $90,000.

(ii) S's gross receipts are calculated as follows:

$90,000	Gross receipts from operations
6,000	Gross interest receipts
1,500	Gross dividend receipts
2,000	Net gain on sale of real property investments
$99,500	Total gross receipts

(iii) Under paragraph (c)(5)(ii)(D) of this section, S's gross interest receipts are not passive investment income. In addition, gain on the sale of real property ($2,000) is not passive investment income. S's passive investment income includes only the $1,500 of gross dividend receipts. Accordingly, S's passive investment income percentage for its first year as an S corporation is 1.51% ($1,500/$99,500). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 8. Interest received in the ordinary course of a lending business. (i) In 1993, S has gross receipts of $100,000 from loans and investments made in the ordinary course of S's mortgage banking business. This includes, for example, mortgage servicing fees, interest earned on mortgages prior to sale of the mortgages, and gain on sale of mortgages. In addition, S receives, from the investment of idle funds in short-term securities, $15,000 of gross interest income and $5,000 of gain.

(ii) S's gross receipts are calculated as follows:

$100,000	Gross receipts from operations
15,000	Gross interest receipts
5,000	Gain on sale of securities
120,000	Total gross receipts

(iii) *S*'s passive investment income is determined as follows:

$15,000	Gross interest receipts
5,000	Gain on sale of securities,
20,000	Total passive investment income

(iv) S's passive investment income percentage for its first year as an S corporation is 16.67% ($20,000/$120,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

[T.D. 8449, 57 FR 55449, Nov. 25, 1992; 58 FR 15274, Mar. 22, 1993, as amended by T.D. 8869, 65 FR 3854, Jan. 25, 2000; T.D. 8995, 67 FR 34610, May 15, 2002]

§ 1.1362–3 Treatment of S termination year.

(a) *In general.* If an S election terminates under section 1362(d) on a date other than the first day of a taxable year of the corporation, the corporation's taxable year in which the termination occurs is an S termination year. The portion of the S termination year ending at the close of the day prior to the termination is treated as a short taxable year for which the corporation is an S corporation (the *S short year*). The portion of the S termination year beginning on the day the termination is effective is treated as a short taxable year for which the corporation is a C corporation (the *C short year*). Except as provided in paragraphs (b) and (c)(1) of this section, the corporation allocates income or loss for the entire year on a pro rata basis as described in section 1362(e)(2). To the extent that income or loss is not allocated on a pro rata basis under this section, items of income, gain, loss, deduction, and credit are assigned to each short taxable year on the basis of the corporation's normal method of accounting as determined under section 446. See, however, §1.1502–76(b)(1)(ii)(A)(*2*) for special rules for an S election that terminates under section 1362(d) immediately before the S corporation becomes a member of a consolidated group (within the meaning of §1.1502–1(h)). See §1.460–4(k)(3)(iv)(D) for rules relating to the computation of the S corporation's income or loss from a contract accounted for under a long-term contract method of accounting in the S termination year.

(b) *Allocations other than pro rata*—(1) *Elections under section 1362(e)(3).* The pro rata allocation rules of section 1362(e)(2) do not apply if the corporation elects to allocate its S termination year income on the basis of its normal tax accounting method. This election may be made only with the consent of each person who is a shareholder in the corporation at any time during the S short year and of each person who is a shareholder in the corporation on the first day of the C short year. See §1.1362–6(a) for rules concerning the time and manner of making this election.

(2) *Purchase of stock treated as an asset purchase.* The pro rata allocation rules of section 1362(e)(2) do not apply with respect to any item resulting from the application of section 338.

(3) *50 percent change in ownership during S termination year.* The pro rata allocation rules of section 1362(e)(2) do not apply if at any time during the S termination year, as a result of sales or exchanges of stock in the corporation during that year, there is a change in ownership of 50 percent or more of the issued and outstanding shares of stock of the corporation. If stock has already been sold or exchanged during the S termination year, subsequent sales or exchanges of that stock are not taken into account for purposes of this paragraph (b)(3).

(c) *Special rules*—(1) *S corporation that is a partner in a partnership.* For purposes of section 706(c) only, the termination of the election of an S corporation that is a partner in a partnership during any portion of the S short year under §1.1362–2 (a) or (b), is treated as a sale or exchange of the corporation's entire interest in the partnership on the last day of the S short year, if—

(i) The pro rata allocation rules do not apply to the corporation; and

(ii) Any taxable year of the partnership ends with or within the C short year.

(2) *Tax for the C short year.* The taxable income for the C short year is determined on an annualized basis as described in section 1362(e)(5).

(3) *Each short year treated as taxable year.* Except as otherwise provided in paragraph (c)(4) of this section, the S and C short years are treated as two separate years for purposes of all provisions of the Internal Revenue Code.

(4) *Year for carryover purposes.* The S and C short years are treated as one year for purposes of determining the number of taxable years to which any item may be carried back or forward by the corporation.

(5) *Due date for S short year return.* The date by which the return for the S short year must be filed is the same as the date by which the return for the C short year must be filed (including extensions).

(6) *Year in which income from S short year is includible.* A shareholder must include in taxable income the shareholder's pro rata share of the items described in section 1366(a) for the S short year for the taxable year with or within which the S termination year ends.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. S termination year not created. (i) On January 1, 1993, the first day of its taxable year, a subchapter C corporation had three eligible shareholders. During 1993, the corporation properly elected to be treated as an S corporation effective January 1, 1994, the first day of the succeeding taxable year. Subsequently, a transfer of some of the stock in the corporation was made to an ineligible shareholder. The ineligible shareholder still holds the stock on January 1, 1994.

(ii) The corporation fails to meet the definition of a small business corporation on January 1, 1994, and its election is treated as having terminated on that date. See §1.1362–2(b)(2) for the termination rules. Because the corporation ceases to be a small business corporation on the first day of a taxable year, an S termination year is not created. In addition, if the corporation in the future meets the definition of a small business corporation and desires to elect to be treated as an S corporation, the corporation is automatically granted consent to reelect before the expiration of the 5-year waiting period. See §1.1362–5 for special rules concerning automatic consent to reelect.

Example 2. More than 50 percent change in ownership during S short year. A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On January 31, 1993, A sells 60 shares of S stock to B, an individual. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on June 1, 1993, and pursuant to section 1362(d)(2), its election terminates on that date. Because there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

Example 3. More than 50 percent change in ownership during C short year. A, an individual, owns all 100 outstanding shares of stock of S, a calendar year S corporation. On June 1, 1993, A sells 5 shares of S stock to PRS, a partnership. S ceases to be a small business corporation on that date and pursuant to section 1362(d)(3), its election terminates on that date. On July 1, 1993, A sells 60 shares of S stock to B, an individual. Since there was a more than 50 percent change in ownership of the issued and outstanding shares of S stock during the S termination year, S must assign the items of income, loss, deduction, or credit for the S termination year to the two short taxable years on the basis of S's normal method of accounting under the rules of paragraph (b)(3) of this section.

Example 4. Stock acquired other than by sale or exchange. C and D are shareholders in S, a calendar year S corporation. Each owns 50 percent of the issued and outstanding shares of the corporation on December 31, 1993. On March 1, 1994, C makes a gift of his entire shareholder interest to T, a trust not permitted as a shareholder under section 1361(c)(2). S ceases to be a small business corporation on March 1, 1994, and pursuant to section 1362(d)(2), its S corporation election terminates effective on that date. As a result of the gift, T owns 50 percent of S's issued and outstanding stock. However, because T acquired the stock by gift from C rather than by sale or exchange, there has not been a more than 50 percent change in ownership by sale or exchange of S that would cause the rules of paragraph (b)(3) of this section to apply.

[T.D. 8449, 57 FR 55452, Nov. 25, 1992, as amended by T.D. 8842, 64 FR 61205, Nov. 10, 1999; T.D. 9137, 69 FR 42559, July 16, 2004]

§ 1.1362–4 Inadvertent terminations and inadvertently invalid elections.

(a) *In general.* A corporation is treated as continuing to be an S corporation or a QSub (or, an invalid election to be either an S corporation or a QSub is treated as valid) during the period specified by the Commissioner if—

(1) The corporation made a valid election under section 1362(a) or section 1361(b)(3) and the election terminated or the corporation made an election under section 1362(a) or section 1361(b)(3) that was invalid;

(2) The Commissioner determines that the termination or invalidity was inadvertent;

(3) Within a reasonable period of time after discovery of the terminating event or invalid election, steps were taken so that the corporation for which the election was made or the termination occurred is a small business corporation or a QSub, as the case may be, or to acquire the required shareholder consents; and

(4) The corporation and shareholders agree to adjustments that the Commissioner may require for the period.

(b) *Inadvertent termination or inadvertently invalid election.* For purposes of paragraph (a) of this section, the determination of whether a termination or invalid election was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination or invalid election was inadvertent. The fact that the terminating event or invalidity of the election was not reasonably within the control of the corporation and, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.

(c) *Corporation's request for determination of an inadvertent termination or invalid election.* A corporation that believes that the termination or invalidity of its election was inadvertent may request a determination from the Commissioner that the termination or invalidity of its election was inadvertent. The request is made in the form of a ruling request and should set forth all relevant facts pertaining to the event or circumstance including, but not limited to, the facts described in paragraph (b) of this section, the date of the corporation's election (or intended election) under section 1362(a) or 1361(b)(3), a detailed explanation of the event or circumstance causing the termination or invalidity, when and how the event or circumstance was discovered, and the steps taken under paragraph (a)(3) of this section.

(d) *Adjustments.* The Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation or QSub during the period specified by the Commissioner. In the case of stock held by an ineligible shareholder that causes an inadvertent termination or invalid election for an S corporation under section 1362(f), the Commissioner may require the ineligible shareholder to be treated as a shareholder of the S corporation during the period the ineligible shareholder actually held stock in the corporation. Moreover, the Commissioner may require protective adjustments that prevent the loss of any revenue due to the holding of stock by an ineligible shareholder (for example, a nonresident alien).

(e) *Corporation and shareholder consents.* The corporation and all persons who were shareholders of the corporation at any time during the period specified by the Commissioner must consent to any adjustments that the Commissioner may require. Each consent should be in the form of a statement agreeing to make the adjustments. The statement must be signed by the shareholder (in the case of shareholder consent) or a person authorized to sign the return required by section 6037 (in the case of corporate consent). See §1.1362–6(b)(2) for persons required to sign consents. A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock. The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

(f) *Status of corporation*. The status of the corporation after the terminating event or invalid election and before the determination of inadvertence is determined by the Commissioner. Inadvertent termination or inadvertent invalid election relief may be granted retroactively for all years for which the terminating event or circumstance giving rise to invalidity is effective, in which case the corporation is treated as if its election was valid or had not terminated. Alternatively, relief may be granted only for the period in which the corporation became eligible for subchapter S or QSub treatment, in which case the corporation is treated as a C corporation or, in the case of a QSub with an inadvertently terminated or invalid election, as a separate C corporation, during the period for which the corporation was not eligible for its intended status.

(g) *Effective/applicability date*. Paragraphs (a), (b), (c), (d), and (f) of this section are effective on *August 14, 2008*.

[T.D. 8449, 57 FR 55453, Nov. 25, 1992, as amended by T.D. 9422, 73 FR 47530, Aug. 14, 2008]

§ 1.1362–5 Election after termination.

(a) *In general*. Absent the Commissioner's consent, an S corporation whose election has terminated (or a successor corporation) may not make a new election under section 1362(a) for five taxable years as described in section 1362(g). However, the Commissioner may permit the corporation to make a new election before the 5-year period expires. The corporation has the burden of establishing that under the relevant facts and circumstances, the Commissioner should consent to a new election. The fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. In the absence of this fact, consent ordinarily is denied unless the corporation shows that the event causing termination was not reasonably within the control of the corporation or shareholders having a substantial interest in the corporation and was not part of a plan on the part of the corporation or of such shareholders to terminate the election.

(b) *Successor corporation*. A corporation is a *successor corporation* to a corporation whose election under section 1362 has been terminated if—

(1) 50 percent or more of the stock of the corporation (the new corporation) is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50 percent or more of the stock of the corporation whose election terminated (the old corporation); and

(2) Either the new corporation acquires a substantial portion of the assets of the old corporation, or a substantial portion of the assets of the new corporation were assets of the old corporation.

(c) *Automatic consent after certain terminations*. A corporation may, without requesting the Commissioner's consent, make a new election under section 1362(a) before the 5-year period described in section 1362(g) expires if the termination occurred because the corporation—

(1) Revoked its election effective on the first day of the first taxable year for which its election was to be effective (see § 1.1362–2(a)(2)); or

(2) Failed to meet the definition of a small business corporation on the first day of the first taxable year for which its election was to be effective (see § 1.1362–2(b)(2)).

[T.D. 8449, 57 FR 55454, Nov. 25, 1992]

§ 1.1362–6 Elections and consents.

(a) *Time and manner of making elections*—(1) *In general*. An election statement made under this section must identify the election being made, set forth the name, address, and taxpayer identification number of the corporation, and be signed by a person authorized to sign the return required to be filed under section 6037.

(2) *Election to be an S corporation*—(i) *Manner of making election*. A small business corporation makes an election

under section 1362(a) to be an S corporation by filing a completed Form 2553. The election form must be filed with the service center designated in the instructions applicable to Form 2553. The election is not valid unless all shareholders of the corporation at the time of the election consent to the election in the manner provided in paragraph (b) of this section. However, once a valid election is made, new shareholders need not consent to that election.

(ii) *Time of making election*—(A) *In general*. The election described in paragraph (a)(2)(i) of this section may be made by a small business corporation at any time during the taxable year that immediately precedes the taxable year for which the election is to be effective, or during the taxable year for which the election is to be effective provided that the election is made before the 16th day of the third month of the year. If a corporation makes an election for a taxable year, and the election meets all the requirements of this section but is made during the period beginning after the 15th day of the third month of the taxable year, the election is treated as being made for the following taxable year provided that the corporation meets all the requirements of section 1361(b) at the time the election is made. For taxable years of 2½ months or less, an election made before the 16th day of the third month after the first day of the taxable year is treated as made during that year.

(B) *Elections made during the first 2½ months treated as made for the following taxable year*. A timely election made by a small business corporation during the taxable year for which it is intended to be effective is nonetheless treated as made for the following taxable year if—

(*1*) The corporation is not a small business corporation during the entire portion of the taxable year which occurs before the date the election is made; or

(*2*) Any person who held stock in the corporation at any time during the portion of the taxable year which occurs before the time the election is made, and who does not hold stock at the time the election is made, does not consent to the election.

(C) *Definition of month and beginning of the taxable year*. *Month* means a period commencing on the same numerical day of any calendar month as the day of the calendar month on which the taxable year began and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the close of the last day of the succeeding calendar month. In addition, the taxable year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever is the first to occur. The existence of incorporators does not necessarily begin the taxable year of a new corporation.

(iii) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. Effective election; no prior taxable year. A calendar year small business corporation begins its first taxable year on January 7, 1993. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins January 7, 1993, and ends before March 22, 1993. Because the corporation had no taxable year immediately preceding the taxable year for which the election is to be effective, an election made earlier than January 7, 1993, will not be valid.

Example 2. Effective election; taxable year less than 2 ½ months. A calendar year small business corporation begins its first taxable year on November 8, 1993. To be an S corporation beginning with its first taxable year, the corporation must make the election set forth in this section during the period that begins November 8, 1993, and ends before January 23, 1994.

Example 3. Election effective for the following taxable year; ineligible shareholder. On January 1, 1993, two individuals and a partnership own all of the stock of a calendar year subchapter C corporation. On January 31, 1993, the partnership dissolved and distributed its shares in the corporation to its five partners, all individuals. On February 28, 1993, the seven shareholders of the corporation consented to the corporation's election of subchapter S status. The corporation files a properly completed Form 2533 on March 2, 1993. The corporation is not eligible to be a subchapter S corporation for the 1993 taxable year because during the period of the taxable year prior to the election it had an ineligible shareholder. However, under paragraph (a)(2)(ii)(B) of this section, the election is treated as made for the corporation's 1994 taxable year.

(3) *Revocation of S election*—(i) *Manner of revoking election.* To revoke an election, the corporation files a statement that the corporation revokes the election made under section 1362(a). The statement must be filed with the service center where the election was properly filed. The revocation statement must include the number of shares of stock (including non-voting stock) issued and outstanding at the time the revocation is made. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. Each shareholder who consents to the revocation must consent in the manner required under paragraph (b) of this section. In addition, each consent should indicate the number of issued and outstanding shares of stock (including non-voting stock) held by each shareholder at the time of the revocation.

(ii) *Time of revoking election.* For rules concerning when a revocation is effective, see § 1.1362–2(a)(2).

(iii) *Examples.* The principles of this paragraph (a)(3) are illustrated by the following examples:

Example 1. Revocation; consent of shareholders owning more than one-half of issued and outstanding shares. A calendar year S corporation has issued an outstanding 40,000 shares of class A voting common stock and 20,000 shares of class B non-voting common stock. The corporation wishes to revoke its election of subchapter S status. Shareholders owning 11,000 shares of class A stock sign revocation consents. Shareholders owning 20,000 shares of class B stock sign revocation consents. The corporation has obtained the required shareholder consent to revoke its subchapter S election because shareholders owning more than one-half of the total number of issued and outstanding shares of stock of the corporation consented to the revocation.

Example 2. Effective prospective revocation. In June 1993, a calendar year S corporation determines that it will revoke its subchapter S election effective August 1, 1993. To do so it must file its revocation statement with consents attached on or before August 1, 1993, and the statement must indicate that the revocation is intended to be effective August 1, 1993.

(4) *Rescission of revocation*—(i) *Manner of rescinding a revocation.* To rescind a revocation, the corporation files a statement that the corporation rescinds the revocation made under section 1362(d)(1). The statement must be filed with the service center where the revocation was properly filed. A rescission may be made only with the consent (in the manner required under paragraph (b)(1) of this section) of each person who consented to the revocation and of each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.

(ii) *Time of rescinding a revocation.* If the rescission statement is filed before the revocation becomes effective and is filed with proper service center, the rescission is effective on the date it is so filed.

(5) *Election not to apply pro rata allocation.* To elect not to apply the pro rata allocation rules to an S termination year, a corporation files a statement that it elects under section 1362(e)(3) not to apply the rules provided in section 1362(e)(2). In addition to meeting the requirements of paragraph (a)(1) of this section, the statement must set forth the cause of the termination and the date thereof. The statement must be filed with the corporation's return for the C short year. This election may be made only with the consent of all persons who are shareholders of the corporation at any time during the S short year and all persons who are shareholders of the corporation on the first day of the C short year (in the manner required under paragraph (b)(1) of this section).

(b) *Shareholders' consents*—(1) *Manner of consents in general.* A shareholder's consent required under paragraph (a) of this section must be in the form of a written statement that sets forth the name, address, and taxpayer identification number of the shareholder, the number of shares of stock owned by the shareholder, the date (or dates) on which the stock was acquired, the date on which the shareholder's taxable year ends, the name of the S corporation, the corporation's taxpayer identification number, and the election to which the shareholder consents. The statement must be signed by the shareholder under penalties of perjury. Except as provided in paragraph (b)(3)(iii) of this section, the election of the corporation is not valid if any required consent is not filed in accordance with the rules contained in this paragraph (b). The consent statement should be attached to the corporation's election statement.

(2) *Persons required to consent.* The following rules apply in determining persons required to consent:

(i) *Community interest in stock.* When stock of the corporation is owned by husband and wife as community property (or the income from the stock is community property), or is owned by tenants in common, joint tenants, or tenants by the entirety, each person having a community interest in the stock or income therefrom and each tenant in common, joint tenant and tenant by the entirety must consent to the election.

(ii) *Minor.* The consent of a minor must be made by the minor or by the legal representative of the minor (or by a natural or an adoptive parent of the minor if no legal representative has been appointed).

(iii) *Estate.* The consent of an estate must be made by an executor or administrator thereof, or by any other fiduciary appointed by testamentary instrument or appointed by the court having jurisdiction over the administration of the estate.

(iv) *Trusts.* In the case of a trust described in section 1361(c)(2)(A) (including a trust treated under section 1361(d)(1)(A) as a trust described in section 1361(c)(2)(A)(i) and excepting an electing small business trust described in section 1361(c)(2)(A)(v) (ESBT)), only the person treated as the shareholder for purposes of section 1361(b)(1) must consent to the election. When stock of the corporation is held by a trust, both husband and wife must consent to any election if the husband and wife have a community interest in the trust property. See paragraph (b)(2)(i) of this section for rules concerning community interests in S corporation stock. In the case of an ESBT, the trustee and the owner of any portion of the trust that consists of the stock in one or more S corporations under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code must consent to the S corporation election. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S corporation election.

(3) *Special rules for consent of shareholder to election to be an S corporation*—(i) *In general.* The consent of a shareholder to an election by a small business corporation under section 1362(a) may be made on Form 2553 or on a separate statement in the manner described in paragraph (b)(1) of this section. In addition, the separate statement must set forth the name, address, and taxpayer identification number of the corporation. A shareholder's consent is binding and may not be withdrawn after a valid election is made by the corporation. Each person who is a shareholder (including any person who is treated as a shareholder under section 1361(c)(2)(B)) at the time the election is made) must consent to the election. If the election is made before the 16th day of the third month of the taxable year and is intended to be effective for that year, each person who was a shareholder (including any person who was treated as a shareholder under section 1361(c)(2)(B)) at any time during the portion of that year which occurs before the time the election is made, and who is not a shareholder at the time the election is made, must also consent to the election. If the election is to be effective for the following taxable year, no consent need be filed by any shareholder who is not a shareholder on the date of the election. Any person who is considered to be a shareholder under applicable State law solely by virtue of his or her status as an incorporator is not treated as a shareholder for purposes of this paragraph (b)(3)(i).

(ii) *Examples.* The principles of this section are illustrated by the following examples:

Example 1. Effective election; shareholder consents. On January 1, 1993, the first day of its taxable year, a subchapter C corporation had 15 shareholders. On January 30, 1993, two of the C corporation's shareholders, A and B, both individuals, sold their shares in the corporation to P, Q, and R, all individuals. On March 1, 1993, the corporation filed its election to be an S corporation for the 1993 taxable year. The election will be effective (assuming the other requirements of section 1361(b) are met) provided that all of the shareholders as of March 1, 1993, as well as former shareholders A and B, consent to the election.

Example 2. Consent of new shareholder unnecessary. On January 1, 1993, three individuals own all of the stock of a calendar year subchapter C corporation. On April 15, 1993, the corporation, in accordance with paragraph (a)(2) of this section, files a properly completed Form 2553. The corporation anticipates that the election will be effective beginning January 1, 1994, the first day of the succeeding taxable year. On October 1, 1993, the three shareholders collectively sell 75% of their shares in the corporation to another individual. On January 1, 1994, the corporation's shareholders are the three original individuals and the new shareholder. Because the election was valid and binding when made, it is not necessary for the new shareholder to consent to the election. The corporation's subchapter S election is effective on January 1, 1994 (assuming the other requirements of section 1361(b) are met).

(iii) *Extension of time for filing consents to an election*—(A) *In general*. An election that is timely filed for any taxable year and that would be valid except for the failure of any shareholder to file a timely consent is not invalid if consents are filed as required under paragraph (b)(3)(iii)(B) of this section and it is shown to the satisfaction of the district director or director of the service center with which the corporation files its income tax return that—

(*1*) There was reasonable cause for the failure to file the consent;

(*2*) The request for the extension of time to file a consent is made within a reasonable time under the circumstances; and

(*3*) The interests of the Government will not be jeopardized by treating the election as valid.

(B) *Required consents*. Consents must be filed within the extended period of time as may be granted by the Internal Revenue Service, by all persons who—

(*1*) Were shareholders of the corporation at any time during the period beginning as of the date of the invalid election and ending on the date on which an extension of time is granted in accordance with this paragraph (b)(3)(iii); and

(*2*) Have not previously consented to the election.

[T.D. 8449, 57 FR 55454, Nov. 25, 1992, as amended by T.D. 8994, 67 FR 34400, May 14, 2002]

§ 1.1362–7 Effective dates.

(a) *In general*. The provisions of §§ 1.1362–1 through 1.1362–6 apply to taxable years of corporations beginning after December 31, 1992. For taxable years to which these regulations do not apply, corporations and shareholders subject to the provisions of section 1362 must take reasonable return positions taking into consideration the statute; its legislative history; the provisions of §§ 18.1362–1 through 18.1362–5 (see 26 CFR part 18 as contained in the CFR edition revised as of April 1, 1992). In addition, following these regulations is a reasonable return position. See Notice 92–56, 1992–49 I.R.B. (see § 601.601(d)(2)(ii)(*b*) of this chapter), for additional guidance regarding reasonable return positions for years to which §§ 1.362–1 through 1.1362–6 do not apply. Section 1.1362–6(b)(2)(iv) is applicable for taxable years beginning on and after May 14, 2002.

(b) *Special effective date for passive investment income provisions*. For taxable years of an S corporation and all affected shareholders that are not closed, the S corporation and all affected shareholders may elect to apply the provisions of § 1.1362–2(c)(5). To make the election, the corporation and all affected shareholders must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made and each subsequent taxable year. For purposes of this section, *affected shareholders* means all shareholders who received distributive shares of S corporation items in the taxable year for which the election is made and all shareholders of the S corporation for all subsequent taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to make this election even if all affected shareholders cannot file consistent returns.

[T.D. 8449, 57 FR 55456, Nov. 25, 1992, as amended by T.D. 8994, 67 FR 34401, May 14, 2002]

§ 1.1362–8 Dividends received from affiliated subsidiaries.

(a) *In general.* For purposes of section 1362(d)(3), if an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term *passive investment income* does not include dividends from the C corporation to the extent those dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business (active earnings and profits). For purposes of applying section 1362(d)(3), earnings and profits of a C corporation are active earnings and profits to the extent that the earnings and profits are derived from activities that would not produce passive investment income (as defined in section 1362(d)(3)) if the C corporation were an S corporation.

(b) *Determination of active or passive earnings and profits*—(1) *In general.* An S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E). Paragraph (b)(5) of this section describes a method of determining the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E) that is deemed to be reasonable under all circumstances.

(2) *Lower tier subsidiaries.* If a C corporation subsidiary (upper tier corporation) holds stock in another C corporation (lower tier subsidiary) meeting the requirements of section 1504(a)(2), the upper tier corporation's gross receipts attributable to a dividend from the lower tier subsidiary are considered to be derived from the active conduct of a trade or business to the extent the lower tier subsidiary's earnings and profits are attributable to the active conduct of a trade or business by the subsidiary under paragraph (b) (1), (3), (4), or (5) of this section. For purposes of this section, distributions by the lower tier subsidiary will be considered attributable to active earnings and profits according to the rule in paragraph (c) of this section. This paragraph (b)(2) does not apply to any member of a consolidated group (as defined in §1.1502–1(h)).

(3) *De minimis exception.* If less than 10 percent of a C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income if the C corporation were an S corporation, all earnings and profits produced by the corporation during that taxable year are considered active earnings and profits.

(4) *Special rules for earnings and profits accumulated by a C corporation prior to 80 percent acquisition.* A C corporation may treat all earnings and profits accumulated by the corporation in all taxable years ending before the S corporation held stock meeting the requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bears to the C corporation's total earnings and profits for those three taxable years.

(5) *Gross receipts safe harbor.* A corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts (as defined in §1.1362–2(c)(4)) derived from activities that would not produce passive investment income (if the C corporation were an S corporation), including those that do not produce passive investment income under paragraphs (b)(2) through (b)(4) of this section, bear to the corporation's total gross receipts for the year in which the earnings and profits are produced.

(c) *Allocating distributions to active or passive earnings and profits*—(1) *Distributions from current earnings and profits.* Dividends distributed by a C corporation from current earnings and profits are attributable to active earnings and profits in the same proportion as current active earnings and profits bear to total current earnings and profits of the C corporation.

(2) *Distributions from accumulated earnings and profits.* Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable

year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

(3) *Adjustments to active earnings and profits.* For purposes of applying paragraph (c) (1) or (2) of this section to a distribution, the active earnings and profits of a corporation shall be reduced by the amount of any prior distribution properly treated as attributable to active earnings and profits from the same taxable year.

(4) *Special rules for consolidated groups.* For purposes of applying section 1362(d)(3) and this section to dividends received by an S corporation from the common parent of a consolidated group (as defined in §1.1502–1(h)), the following rules apply—

(i) The current earnings and profits, accumulated earnings and profits, and active earnings and profits of the common parent shall be determined under the principles of §1.1502–33 (relating to earnings and profits of any member of a consolidated group owning stock of another member); and

(ii) The gross receipts of the common parent shall be the sum of the gross receipts of each member of the consolidated group (including the common parent), adjusted to eliminate gross receipts from intercompany transactions (as defined in §1.1502–13(b)(1)(i)).

(d) *Examples.* The following examples illustrate the principles of this section:

Example 1. (i) X, an S corporation, owns 85 percent of the one class of stock of Y. On December 31, 2002, Y declares a dividend of $100 ($85 to X), which is equal to Y's current earnings and profits. In 2002, Y has total gross receipts of $1,000, $200 of which would be passive investment income if Y were an S corporation.

(ii) One-fifth ($200/$1,000) of Y's gross receipts for 2002 is attributable to activities that would produce passive investment income. Accordingly, one-fifth of the $100 of earnings and profits is passive, and $17 (1⁄5 of $85) of the dividend from Y to X is passive investment income.

Example 2. (i) The facts are the same as in *Example 1*, except that Y owns 90 percent of the stock of Z. Y and Z do not join in the filing of a consolidated return. In 2002, Z has gross receipts of $15,000, $12,000 of which are derived from activities that would produce passive investment income. On December 31, 2002, Z declares a dividend of $1,000 ($900 to Y) from current earnings and profits.

(ii) Four-fifths ($12,000/$15,000) of the dividend from Z to Y are attributable to passive earnings and profits. Accordingly, $720 (4⁄5 of $900) of the dividend from Z to Y is considered gross receipts from an activity that would produce passive investment income. The $900 dividend to Y gives Y a total of $1,900 ($1,000 + $900) in gross receipts, $920 ($200 + $720) of which is attributable to passive investment income-producing activities. Under these facts, $41 ($920/$1,900 of $85) of Y's distribution to X is passive investment income to X.

(e) *Effective date.* This section applies to dividends received in taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part, for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

[T.D. 8869, 65 FR 3854, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000]

§ 1.1363–1 Effect of election on corporation.

(a) *Exemption of corporation from income tax*—(1) *In general.* Except as provided in this paragraph (a), a small business corporation that makes a valid election under section 1362(a) is exempt from the taxes imposed by chapter 1 of the Internal Revenue Code with respect to taxable years of the corporation for which the election is in effect.

(2) *Corporate level taxes.* An S corporation is not exempt from the tax imposed by section 1374 (relating to the tax imposed on certain built-in gains), or section 1375 (relating to the tax on excess passive investment income). See also section 1363(d) (relating to the recapture of LIFO benefits) for the rules regarding the payment by an S corporation of LIFO recapture amounts.

(b) *Computation of corporate taxable income*. The taxable income of an S corporation is computed as described in section 1363(b).

(c) *Elections of the S corporation*—(1) *In general*. Any elections (other than those described in paragraph (c)(2) of this section) affecting the computation of items derived from an S corporation are made by the corporation. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, are made by the corporation and not by the shareholders separately. All corporate elections are applicable to all shareholders.

(2) *Exceptions*. (i) Each shareholder's pro rata share of expenses described in section 617 paid or accrued by the S corporation is treated according to the shareholder's method of treating those expenses, notwithstanding the treatment of the expenses by the corporation.

(ii) Each shareholder may elect to amortize that shareholder's pro rata share of any qualified expenditure described in section 59(e) paid or accrued by the S corporation.

(iii) Each shareholder's pro rata share of taxes described in section 901 paid or accrued by the S corporation to foreign countries or possessions of the United States (according to its method of treating those taxes) is treated according to the shareholder's method of treating those taxes, and each shareholder may elect to use the total amount either as a credit against tax or as a deduction from income.

(d) *Effective date*. This section applies to taxable years of corporations beginning after December 31, 1992. For taxable years to which this section does not apply, corporations and shareholders subject to the provisions of section 1363 must take reasonable return positions taking into consideration the statute, its legislative history and these regulations. See Notice 92–56, 1992–49 I.R.B. (see § 601.601(d)(2)(ii)(*b*) of this chapter), for additional guidance regarding reasonable return positions for taxable years to which this section does not apply.

[T.D. 8449, 57 FR 55456, Nov. 25, 1992]

§ 1.1363–2 Recapture of LIFO benefits.

(a) *In general*. A C corporation must include the LIFO recapture amount (as defined in section 1363(d)(3)) in its gross income—

(1) In its last taxable year as a C corporation if the corporation inventoried assets under the LIFO method for its last taxable year before its S corporation election becomes effective; or

(2) In the year of transfer by the C corporation to an S corporation of the LIFO inventory assets if paragraph (a)(1) of this section does not apply and the C corporation—

(i) Inventoried assets under the LIFO method during the taxable year of the transfer of those LIFO inventory assets; and

(ii) Transferred the LIFO inventory assets to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred assets constitute transferred basis property (within the meaning of section 7701(a)(43)).

(b) *LIFO inventory held indirectly through partnership*. A C corporation must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(4) of this section) in its gross income—

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(3) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) *Definitions and special rules*—(1) *Recapture date*. In the case of a transaction described in paragraph (a)(1) or (b)(1) of this section, the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (a)(2) or (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation.

(2) *Determination of LIFO recapture amount.* The LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (a)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (a)(2) of this section.

(3) *Lookthrough partnership interest.* A partnership interest is a lookthrough partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(4) *Lookthrough LIFO recapture amount*—(i) *In general.* For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and §1.704–3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471, determined in accordance with section 1363(d)(4)(C).

(ii) *Determination of lookthrough LIFO recapture amount.* Except as provided in paragraph (c)(4)(iii) of this section, the lookthrough LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (b)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (b)(2) of this section.

(iii) *Alternative rule.* If the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date. A partnership that applies the alternative method of this paragraph (c)(4)(iii) to calculate the lookthrough LIFO recapture amount must take into account any adjustments to the partnership's basis in its LIFO inventory that result from transactions occurring after the start of the partnership's taxable year and before the end of the recapture date. For example, the lookthrough LIFO recapture amount must be adjusted to take into account any adjustments to the basis of LIFO inventory during that period under sections 734(b), 737(c), or 751(b).

(d) *Payment of tax.* Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid—

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) *Basis adjustments*—(1) *General rule.* Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) *LIFO inventory owned through a partnership*—(i) *Basis of corporation's*

partnership interest. Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) *Basis of partnership assets.* A partnership directly holding LIFO inventory that is taken into account under paragraph (b) of this section may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership, LIFO inventory that is taken into account under paragraph (b) of this section may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See §1.743–1(j).

(3) *Election.* A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under this paragraph (e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

(f) *Examples.* The following examples illustrate the rules of this section:

Example 1. (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory, and there are no other adjustments to the partnership's basis in its LIFO inventory between January 1, 2005 and the end of the recapture date. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005 under paragraph (c)(1) of this section. GH elects to use the LIFO method for the inventory and determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the inventory contributed by G, are $200 and $120, respectively.

(ii) Under paragraph (c)(4)(iii) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(4) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value ($200) exceeds the LIFO value ($120) in GH's opening inventory is $80. Thus, if GH sold all of its LIFO inventory for $200, it would recognize $80 of income. G's lookthrough LIFO recapture amount is $80, the amount of income that would be allocated to G, taking into account section 704(c) and §1.704–3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include $80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by $80. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by $80.

Example 2. (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004 under paragraph (c)(1) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004 are $240 and $140, respectively.

(ii) The amount by which the FIFO value ($240) exceeds the LIFO value ($140) on the recapture date is $100. Thus, if JK sold all of its LIFO inventory for $240, it would recognize $100 of income. J's lookthrough LIFO recapture amount is $30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of $100). Under paragraph (b)(1) of this section, J must include $30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by $30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by $30.

(g) *Effective dates.* (1) The provisions of paragraph (a)(1) of this section apply to S elections made after December 17, 1987. For an exception, see section 10227(b)(2) of the Revenue Act of 1987.

(2) The provisions of paragraph (a)(2) of this section apply to transfers made after August 18, 1993.

(3) The provisions of paragraphs (b), (c), (d), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004. The rules that apply to S elections and transfers made before August 13, 2004, are contained in § 1.1363–2 as in effect prior to August 13, 2004 (see 26 CFR part 1 revised as of April 1, 2005).

[T.D. 8567, 59 FR 51106, Oct. 7, 1994, as amended by T.D. 9210, 70 FR 39921, July 12, 2005]

§ 1.1366–0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1366–1 through 1.1366–5:

[T.D. 8852, 64 FR 71644, Dec. 22, 1999, as amended by T.D. 9422, 73 FR 47530, Aug. 14, 2008; T.D. 9682, 79 FR 42677, July 23, 2014]

§ 1.1366–1 Shareholder's share of items of an S corporation.

(a) *Determination of shareholder's tax liability*—(1) *In general.* An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. For the limitation on allowance of a shareholder's pro rata share of S corporation losses or deductions, see section 1366(d) and §1.1366–2.

(2) *Separately stated items of income, loss, deduction, or credit.* Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately. The separately stated items of the S corporation include, but are not limited to, the following items—

(i) The corporation's combined net amount of gains and losses from sales or exchanges of capital assets grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(ii) The corporation's combined net amount of gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(iii) Charitable contributions, grouped by the percentage limitations of section 170(b), paid by the corporation within the taxable year of the corporation;

(iv) The taxes described in section 901 that have been paid (or accrued) by the corporation to foreign countries or to possessions of the United States;

(v) Each of the corporation's separate items involved in the determination of credits against tax allowable under part IV of subchapter A (section 21 and following) of the Internal Revenue Code, except for any credit allowed under section 34 (relating to certain uses of gasoline and special fuels);

(vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); deduction under an election to expense certain depreciable business expenses (section 179); medical, dental, etc., expenses (section 213); the additional itemized deductions for individuals provided in part VII of subchapter B (section 212 and following) of the Internal Revenue Code; and any other itemized deductions for which the limitations on itemized deductions under sections 67 or 68 applies;

(vii) Any of the corporation's items of portfolio income or loss, and expenses related thereto, as defined in the regulations under section 469;

(viii) The corporation's tax-exempt income. For purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 (income from discharge of indebtedness) or section 109 (improvements by lessee on lessor's property) is not tax-exempt income;

(ix) The corporation's adjustments described in sections 56 and 58, and items of tax preference described in section 57; and

(x) Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

(3) *Nonseparately computed income or loss.* Each shareholder must take into account separately the shareholder's pro rata share of the nonseparately computed income or loss of the S corporation. For this purpose, nonseparately computed income or loss means the corporation's gross income less the deductions allowed to the corporation under chapter 1 of the Internal Revenue Code, determined by excluding any item requiring separate computation under paragraph (a)(2) of this section.

(4) *Separate activities requirement.* An S corporation must report, and each shareholder must take into account in the shareholder's return, the shareholder's pro rata share of an S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2) and (3) of this section for each of the corporation's activities as defined in section 469 and the regulations thereunder.

(5) *Aggregation of deductions or exclusions for purposes of limitations*—(i) *In general.* A shareholder aggregates the shareholder's separate deductions or exclusions with the shareholder's pro rata share of the S corporation's separately stated deductions or exclusions in determining the amount of any deduction or exclusion allowable to the shareholder under subtitle A of the Internal Revenue Code as to which a limitation is imposed.

(ii) *Example.* The provisions of paragraph (a)(5)(i) of this section are illustrated by the following example:

Example. In 1999, Corporation M, a calendar year S corporation, purchases and places in service section 179 property costing $10,000. Corporation M elects to expense the entire cost of the property. Shareholder A owns 50 percent of the stock of Corporation M. Shareholder A's pro rata share of this item after Corporation M applies the section 179(b) limitations is $5,000. Because the aggregate amount of Shareholder A's pro rata share and separately acquired section 179 expense may not exceed $19,000 (the aggregate maximum cost that may be taken into account under section 179(a) for the applicable taxable year), Shareholder A may elect to expense up to $14,000 of separately acquired section 179 property that is purchased and placed in service in 1999, subject to the limitations of section 179(b).

(b) *Character of items constituting pro rata share*—(1) *In general.* Except as provided in paragraph (b)(2) or (3) of this section, the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section is determined for the S corporation and retains that character in the hands of the shareholder. For example, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain regardless of whether the shareholder is otherwise a dealer in that type of property. Similarly, if an S corporation engages in an activity that is not for profit (as defined in section 183), a shareholder's pro rata share of the S corporation's deductions will be characterized as not for profit. Also, if an S corporation makes a charitable contribution to an organization qualifying under section 170(b)(1)(A), a shareholder's pro rata share of the S corporation's charitable contribution will be characterized as made to an organization qualifying under section 170(b)(1)(A).

(2) *Exception for contribution of noncapital gain property.* If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would not have produced capital gain if sold or exchanged by the shareholder or shareholders, then the gain on the sale or exchange of the property recognized by the corporation is not treated as a capital gain.

(3) *Exception for contribution of capital loss property.* If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would have produced capital loss if sold or exchanged by the shareholder or shareholders, then the loss on the sale or exchange of the property recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution,

the adjusted basis of the property in the hands of the shareholder or shareholders exceeded the fair market value of the property.

(c) *Gross income of a shareholder*—(1) *In general.* Where it is necessary to determine the amount or character of the gross income of a shareholder, the shareholder's gross income includes the shareholder's pro rata share of the gross income of the S corporation. The shareholder's pro rata share of the gross income of the S corporation is the amount of gross income of the corporation used in deriving the shareholder's pro rata share of S corporation taxable income or loss (including items described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section). For example, a shareholder is required to include the shareholder's pro rata share of S corporation gross income in computing the shareholder's gross income for the purposes of determining the necessity of filing a return (section 6012(a)) and the shareholder's gross income derived from farming (sections 175 and 6654(i)).

(2) *Gross income for substantial omission of items*—(i) *In general.* For purposes of determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a shareholder's gross income includes the shareholder's pro rata share of S corporation gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of S corporation gross income used in deriving the shareholder's pro rata share of any item of S corporation income, loss, deduction, or credit (as included or disclosed in the shareholder's return) is considered as an amount of gross income stated in the shareholder's return for purposes of section 6501(e).

(ii) *Example.* The following example illustrates the provisions of paragraph (c)(2)(i) of this section:

Example. Shareholder A, an individual, owns 25 percent of the stock of Corporation N, an S corporation that has $10,000 gross income and $2,000 taxable income. A reports only $300 as A's pro rata share of N's taxable income. A should have reported $500 as A's pro rata share of taxable income, derived from A's pro rata share, $2,500, of N's gross income. Because A's return included only $300 without a disclosure meeting the requirements of section 6501(e)(1)(A)(ii) describing the difference of $200, A is regarded as having reported on the return only $1,500 ($300/$500 of $2,500) as gross income from N.

(d) *Shareholders holding stock subject to community property laws.* If a shareholder holds S corporation stock that is community property, then the shareholder's pro rata share of any item or items listed in paragraphs (a)(2), (3), and (4) of this section with respect to that stock is reported by the husband and wife in accordance with community property rules.

(e) *Net operating loss deduction of shareholder of S corporation.* For purposes of determining a net operating loss deduction under section 172, a shareholder of an S corporation must take into account the shareholder's pro rata share of items of income, loss, deduction, or credit of the corporation. See section 1366(b) and paragraph (b) of this section for rules on determining the character of the items. In determining under section 172(d)(4) the nonbusiness deductions allowable to a shareholder of an S corporation (arising from both corporation sources and any other sources), the shareholder separately takes into account the shareholder's pro rata share of the deductions of the corporation that are not attributable to a trade or business and combines this amount with the shareholder's nonbusiness deductions from any other sources. The shareholder also separately takes into account the shareholder's pro rata share of the gross income of the corporation not derived from a trade or business and combines this amount with the shareholder's nonbusiness income from all other sources. See section 172 and the regulations thereunder.

(f) *Cross-reference.* For rules relating to the consistent tax treatment of subchapter S items, see section 6037(c).

[T.D. 8852, 64 FR 71645, Dec. 22, 1999]

§ 1.1366–2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) *In general*—(1) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under § 1.1366–1(a) (2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(4)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraphs (a)(2) and (a)(4)(ii) of this section).

(2) *Basis of indebtedness*—(i) *In general*. The term *basis of any indebtedness of the S corporation to the shareholder* means the shareholder's adjusted basis (as defined in §1.1011–1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

(ii) *Special rule for guarantees*. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.

(iii) *Examples*. The following examples illustrate the provisions of paragraph (a)(2)(i) and (ii) of this section:

Example 1. Shareholder loan transaction. A is the sole shareholder of S, an S corporation. S received a loan from A. Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness under paragraph (a)(2)(i) of this section. The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under §301.7701–3 of this chapter.

Example 2. Back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 3. Loan restructuring through distributions. A is the sole shareholder of two S corporations, S1 and S2. In May 2014, S1 made a loan to S2. In December 2014, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 4. Guarantee. A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

(3) *Carryover of disallowance*. A shareholder's aggregate amount of losses and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(4) (i) and (ii) of this section.

(4) *Basis limitation amount*—(i) *Stock portion*. A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (3)

of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2) (A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2) (B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under §1.1367–1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2) (D) and (E). This basis limitation amount for stock is determined at the time prescribed under §1.1367–1(d)(1) for adjustments to the basis of stock.

(ii) *Indebtedness portion.* A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (3) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time prescribed under §1.1367–2(d)(1) for adjustments to the basis of indebtedness.

(5) *Limitation on losses and deductions allocated to each item.* If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in §1.1366–1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(4)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(4)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(6) *Nontransferability of losses and deductions*—(i) *In general.* Except as provided in paragraph (a)(6)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(ii) *Exceptions for transfers of stock under section 1041(a).* If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) of this section for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(5) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock and the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii) *Examples*. The following examples illustrates the provisions of paragraph (a)(6)(ii) of this section:

Example 1. *A* owns all 100 shares in *X*, a calendar year S corporation. For *X*'s taxable year ending December 31, 2006, *A* has zero basis in the shares and *X* does not have any indebtedness to *A*. For the 2006 taxable year, *X* had $100 in losses that *A* cannot use because of the basis limitation in section 1366(d)(1) and that are treated as incurred by the corporation with respect to *A* in the following taxable year. Halfway through the 2007 taxable year, *A* transfers 50 shares to *B*, *A*'s former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, *X* has $80 in losses. On *A*'s 2007 individual income tax return, *A* may use the entire $100 carryover loss from 2006, as well as *A*'s share of the $80 2007 loss determined under section 1377(a) ($60), assuming A acquires sufficient basis in the *X* stock. On *B*'s 2007 individual income tax return, *B* may use *B*'s share of the $80 2007 loss determined under section 1377(a) ($20), assuming *B* has sufficient basis in the *X* stock. If any disallowed 2006 loss is disallowed to *A* under section 1366(d)(1) in 2007, that loss is prorated between *A* and *B* based on their stock ownership at the beginning of 2008. On *B*'s 2008 individual income tax return, *B* may use that loss, assuming *B* acquires sufficient basis in the *X* stock. If neither *A* nor *B* acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring $50 of loss with respect to *A* and $50 of loss with respect to *B* for the $100 of disallowed 2006 loss, and the corporation will be treated as incurring $60 of loss with respect to *A* and $20 with respect to *B* for the $80 of disallowed 2007 loss.

Example 2. Assume the same facts as *Example 1*, except that during the 2007 taxable year, *A* acquires $10 of basis in *A*'s shares in *X*. For the 2007 taxable year, *A* may claim a $10 loss deduction, which represents $6.25 of the disallowed 2006 loss of $100 and $3.75 of *A*'s 2007 loss of $60. The disallowed 2006 loss is reduced to $93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining $93.75 of loss with respect to *A* and half of that loss with respect to *B* for the remaining $93.75 of disallowed 2006 loss, and if *B* does not acquire any basis during 2007, the corporation will be treated as incurring $56.25 of loss with respect to *A* and $20 with respect to *B* for the remaining disallowed 2007 loss.

(7) *Basis of stock acquired by gift*. For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (3) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(b) *Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b)*—(1) *In general*. If, for the last taxable year of a corporation for which it was an S corporation, a loss or deduction was disallowed to a shareholder by reason of the limitation in paragraph (a) of this section, the loss or deduction is treated under section 1366(d)(3) as incurred by that shareholder on the last day of any post-termination transition period (within the meaning of section 1377(b)).

(2) *Limitation on losses and deductions*. The aggregate amount of losses and deductions taken into account by a shareholder under paragraph (b)(1) of this section cannot exceed the adjusted basis of the shareholder's stock in the corporation determined at the close of the last day of the post-termination transition period. For this purpose, the adjusted basis of a shareholder's stock in the corporation is determined at the close of the last day of the post-termination transition period without regard to any reduction required under paragraph (b)(4) of this section. If a shareholder disposes of a share of stock prior to the close of the last day of the post-termination transition period, the adjusted basis of that share is its basis as of the close of the day of disposition. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph (b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(3) *Limitation on losses and deductions allocated to each item*. If the aggregate amount of losses and deductions treated as incurred by the shareholder under paragraph (b)(1) of this section exceeds the adjusted basis of the shareholder's stock determined under paragraph (b)(2) of this section, the limitation on losses and deductions under section 1366(d)(3)(B) must be allocated among

each loss or deduction. The amount of the limitation allocated to each loss or deduction is an amount that bears the same ratio to the amount of the limitation as the amount of each loss or deduction bears to the total of all the losses and deductions.

(4) *Adjustment to the basis of stock.* The shareholder's basis in the stock of the corporation is reduced by the amount allowed as a deduction by reason of this paragraph (b). For rules regarding adjustments to the basis of a shareholder's stock in an S corporation, see §1.1367–1.

(c) *Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions*—(1) *Liquidations and reorganizations.* If a corporation acquires the assets of an S corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. See the special rules under section 1377 for the availability of the post-termination transition period if the acquiring corporation is a C corporation.

(2) *Corporate separations to which section 368(a)(1)(D) applies.* If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. Such allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.

[T.D. 8852, 64 FR 71646, Dec. 22, 1999, as amended by T.D. 9422, 73 FR 47531, Aug. 14, 2008; T.D. 9682, 79 FR 42678, July 23, 2014]

§1.1366–3 Treatment of family groups.

(a) *In general.* Under section 1366(e), if an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to those items taken into account by the individual and the shareholders as may be necessary to reflect the value of the services rendered or capital furnished. For these purposes, in determining the reasonable value for services rendered, or capital furnished, to the corporation, consideration will be given to all the facts and circumstances, including the amount that ordinarily would be paid in order to obtain comparable services or capital from a person (other than a member of the family) who is not a shareholder in the corporation. In addition, for purposes of section 1366(e), if a member of the family of one or more shareholders of the S corporation holds an interest in a passthrough entity (e.g., a partnership, S corporation, trust, or estate), that performs services for, or furnishes capital to, the S corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to the passthrough entity and the corporation as may be necessary to reflect the value of the services rendered or capital furnished. For purposes of section 1366(e), the term *family* of any shareholder includes only the shareholder's spouse, ancestors, lineal descendants, and any trust for the primary benefit of any of these persons.

(b) *Examples*. The provisions of this section may be illustrated by the following examples:

Example 1. The stock of an S corporation is owned 50 percent by F and 50 percent by T, the minor son of F. For the taxable year, the corporation has items of taxable income equal to $70,000. Compensation of $10,000 is paid by the corporation to F for services rendered during the taxable year, and no compensation is paid to T, who rendered no services. Based on all the relevant facts and circumstances, reasonable compensation for the services rendered by F would be $30,000. In the discretion of the Internal Revenue Service, up to an additional $20,000 of the $70,000 of the corporation's taxable income, for tax purposes, may be allocated to F as compensation for services rendered. If the Internal Revenue Service allocates $20,000 of the corporation's taxable income to F as compensation for services, taxable income of the corporation would be reduced by $20,000 to $50,000, of which F and T each would be allocated $25,000. F would have $30,000 of total compensation paid by the corporation for services rendered.

Example 2. The stock of an S corporation is owned by A and B. For the taxable year, the corporation has paid compensation to a partnership that rendered services to the corporation during the taxable year. The spouse of A is a partner in that partnership. Consequently, if based on all the relevant facts and circumstances the partnership did not receive reasonable compensation for the services rendered to the corporation, the Internal Revenue Service, in its discretion, may make adjustments to those items taken into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999]

§ 1.1366–4 Special rules limiting the passthrough of certain items of an S corporation to its shareholders.

(a) *Passthrough inapplicable to section 34 credit*. Section 1.1366–1(a) does not apply to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels).

(b) *Reduction in passthrough for tax imposed on built-in gains*. For purposes of § 1.1366–1(a), if for any taxable year of the S corporation a tax is imposed on the corporation under section 1374, the amount of the tax imposed is treated as a loss sustained by the S corporation during the taxable year. The character of the deemed loss is determined by allocating the loss proportionately among the net recognized built-in gains giving rise to the tax and attributing the character of each net recognized built-in gain to the allocable portion of the loss.

(c) *Reduction in passthrough for tax imposed on excess net passive income*. For purposes of § 1.1366–1(a), if for any taxable year of the S corporation a tax is imposed on the corporation under section 1375, each item of passive investment income shall be reduced by an amount that bears the same ratio to the amount of the tax as the net amount of the item bears to the total net passive investment income for that taxable year.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000]

§ 1.1366–5 Effective/applicability date.

(a) Sections 1.1366–1, 1.1366–2(a)(1), and 1.1366–2(b) through 1.1366–4 apply to taxable years of an S corporation beginning on or after August 18, 1998.

(b) Section 1.1366–2(a)(2) applies to indebtedness between an S corporation and its shareholder resulting from any transaction occurring on or after July 23, 2014. In addition, S corporations and their shareholders may rely on § 1.1366–2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

(c) Sections 1.1366–2(a)(3) through (7), and this section apply on and after July 23, 2014. For rules that apply before that date, see 26 CFR part 1 (revised as of April 1, 2014).

[T.D. 9682, 79 FR 42678, July 23, 2014]

§ 1.1367–0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1367–1 through 1.1367–3.

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999]

§ 1.1367–1 Adjustments to basis of shareholder's stock in an S corporation.

(a) *In general*—(1) *Adjustments under section 1367.* This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) *Applicability of other Internal Revenue Code provisions.* In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) *Increase in basis of stock*—(1) *In general.* Except as provided in § 1.1367–2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) *Amount of increase in basis of individual shares.* The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) *Decrease in basis of stock*—(1) *In general.* The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) *Noncapital, nondeductible expenses.* For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (*noncapital, nondeductible expenses*) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible

under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162. For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see § 1.362–4(e)(2).

(3) *Amount of decrease in basis of individual shares.* The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) *Time at which adjustments to basis of stock are effective*—(1) *In general.* The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) *Adjustment for nontaxable item.* An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.

(3) *Effect of election under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest is terminated or a qualifying disposition occurs, whichever the case may be.

(e) *Ordering rules for taxable years beginning before January 1, 1997.* For any taxable year of a corporation beginning before January 1, 1997, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order—

(1) Any increase in basis attributable to the income items described in section 1367(a)(1) (A) and (B) and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D) and the oil and gas depletion deduction described in section 1367(a)(2)(E);

(3) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2) (B) and (C); and

(4) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A).

(f) *Ordering rules for taxable years beginning on or after August 18, 1998.* For any taxable year of a corporation beginning on or after August 18, 1998, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order—

(1) Any increase in basis attributable to the income items described in section 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A);

(3) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D), and the oil and gas depletion deduction described in section 1367(a)(2)(E); and

(4) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2)(B) and (C).

(g) *Elective ordering rule.* A shareholder may elect to decrease basis under paragraph (e)(3) or (f)(4) of this section, whichever applies, prior to decreasing basis under paragraph (e)(2) or (f)(3) of this section, whichever applies.

If a shareholder makes this election, any amount described in paragraph (e)(2) or (f)(3) of this section, whichever applies, that is in excess of the shareholder's basis in stock and indebtedness is treated, solely for purposes of this section, as an amount described in paragraph (e)(2) or (f)(3) of this section, whichever applies, in the succeeding taxable year. A shareholder makes the election under this paragraph by attaching a statement to the shareholder's timely filed original or amended return that states that the shareholder agrees to the carryover rule of the preceding sentence. Once a shareholder makes an election under this paragraph with respect to an S corporation, the shareholder must continue to use the rules of this paragraph for that S corporation in future taxable years unless the shareholder receives the permission of the Commissioner.

(h) *Examples*. The following examples illustrate the principles of §1.1367–1. In each example, the corporation is a calendar year S corporation:

Example 1. Adjustments to basis of stock for taxable years beginning before January 1, 1997. (i) On December 31, 1994, A owns a block of 50 shares of stock with an adjusted basis per share of $6 in Corporation S. On December 31, 1994, A purchases for $400 an additional block of 50 shares of stock with an adjusted basis of $8 per share. Thus, A holds 100 shares of stock for each day of the 1995 taxable year. For S's 1995 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is $300, and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) and (D) (relating to decreases in basis of stock) is $500. S makes a distribution to A in the amount of $100 during 1995.

(ii) Pursuant to the ordering rules of paragraph (e) of this section, A increases the basis of each share of stock by $3 ($300/100 shares) and decreases the basis of each share of stock by $5 ($500/100 shares). Then A reduces the basis of each share by $1 ($100/100 shares) for the distribution. Thus, on January 1, 1996, A has a basis of $3 per share in his original block of 50 shares ($6 + $3 − $5 − $1) and a basis of $5 per share in the second block of 50 shares ($8 + $3 − $5 − $1).

Example 2. Adjustments to basis of stock for taxable years beginning on or after August 18, 1998. (i) On December 31, 2001, A owns a block of 50 shares of stock with an adjusted basis per share of $6 in Corporation S. On December 31, 2001, A purchases for $400 an additional block of 50 shares of stock with an adjusted basis of $8 per share. Thus, A holds 100 shares of stock for each day of the 2002 taxable year. For S's 2002 taxable year, A's pro rata share of the amount of items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is $300, A's pro rata share of the amount of the items described in section 1367(a)(2)(B) (relating to decreases in basis of stock attributable to items of loss and deduction) is $300, and A's pro rata share of the amount of the items described in section 1367(a)(2)(D) (relating to decreases in basis of stock attributable to noncapital, nondeductible expenses) is $200. S makes a distribution to A in the amount of $100 during 2002.

(ii) Pursuant to the ordering rules of paragraph (f) of this section, A first increases the basis of each share of stock by $3 ($300/100 shares) and then decreases the basis of each share by $1 ($100/100 shares) for the distribution. A next decreases the basis of each share by $2 ($200/100 shares) for the noncapital, nondeductible expenses and then decreases the basis of each share by $3 ($300/100 shares) for the items of loss. Thus, on January 1, 2003, A has a basis of $3 per share in the original block of 50 shares ($6 + $3 − $1 − $2 − $3) and a basis of $5 per share in the second block of 100 shares ($8 + $3 − $1 − $2 − $3).

Example 3. Adjustments attributable to basis of individual shares of stock. (i) On December 31, 1993, B owns one share of S corporation's 10 outstanding shares of stock. The basis of B's share is $30. On July 2, 1994, B purchases from another shareholder two shares for $25 each. During 1994, S corporation has no income or deductions but incurs a loss of $365. Under section 1377(a)(1)(A) and paragraph (c)(3) of this section, the amount of the loss assigned to each day of S's taxable year is $1.00 ($365/365 days). For each day, $.10 is allocated to each outstanding share ($1.00 amount of loss assigned to each day/10 shares).

(ii) B owned one share for 365 days and, therefore, reduces the basis of that share by the amount of loss attributable to it, i.e., $36.50 ($.10 × 365 days). B owned two shares for 182 days and, therefore, reduces the basis of each of those shares by the amount of the loss attributable to each, i.e., $18.20 ($.10 × 182 days).

(iii) The bases of the shares are decreased as follows:

Share	Original basis	Decrease	Adjusted basis	Excess basis reduction
No. 1	$30.00	$36.50	$0	$6.50
No. 2	25.00	18.20	6.80	0
No. 3	25.00	18.20	6.80	0
Total remaining basis			13.60	

(iv) Because the decrease in basis attributable to share No. 1 exceeds the basis of share No. 1 by $6.50 ($36.50 − $30.00), the excess is applied to reduce the bases of shares No. 2 and No. 3 in proportion to their remaining bases. Therefore, the bases of share No. 2 and share No. 3 are each decreased by an additional $3.25 ($6.50 × $6.80/$13.60). After this decrease, Share No. 1 has a basis of zero, Share No. 2 has a basis of $3.55, and Share No. 3 has a basis of $3.55.

Example 4. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning before January 1, 1997. (i) On January 1, 1994, individuals B and C each own 50 of the 100 shares of issued and outstanding stock of Corporation S. B's adjusted basis in each share of stock is $120, and C's is $80. On June 30, 1994, S distributes $6,000 to B and $6,000 to C. On June 30, 1994, B sells all of her S stock for $10,000 to D. S elects under section 1377(a)(2) to treat its 1994 taxable year as consisting of two taxable years, the first of which ends at the close of June 30, the date on which B terminates her interest in S.

(ii) For the period January 1, 1994, through June 30, 1994, S has nonseparately computed income of $6,000 and a separately stated deduction item of $4,000. Therefore, on June 30, 1994, B and C, pursuant to the ordering rules of paragraph (e) of this section, increase the basis of each share by $60 ($6,000/100 shares) and decrease the basis of each share by $40 ($4,000/100 shares). Then B and C reduce the basis of each share by $120 ($12,000/100 shares) for the distribution.

(iii) The basis of B's stock is reduced from $120 to $20 per share ($120 + $60 − $40 − $120). The basis of C's stock is reduced from $80 to $0 per share ($80 + $60 − $40 − $120). See section 1368 and § 1.1368–1 (c) and (d) for rules relating to the tax treatment of the distributions.

(iv) Pursuant to paragraph (d)(3) of this section, the net reduction in the basis of B's shares of the S stock required by section 1367 and this section is effective immediately prior to B's sale of her stock. Thus, B's basis for determining gain or loss on the sale of the S stock is $20 per share, and B has a gain on the sale of $180 ($200 − $20) per share.

Example 5. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning on or after August 18, 1998. (i) The facts are the same as in *Example 4*, except that all of the events occur in 2001 rather than in 1994 and except as follows: On June 30, 2001, B sells 25 shares of her stock for $5,000 to D and 25 shares back to Corporation S for $5,000. Under section 1377(a)(2)(B) and § 1.1377–1(b)(2), B, C, and D are affected shareholders because B has transferred shares to Corporations S and D. Pursuant to section 1377(a)(2)(A) and § 1.1377–1(b)(1), B, C, and D, the affected shareholders, and Corporation S agree to treat the taxable year 2001 as if it consisted of two separate taxable years for all affected shareholders for the purposes set forth in § 1.1377–1(b)(3)(i).

(ii) On June 30, 2001, B and C, pursuant to the ordering rules of paragraph (f)(1) of this section, increase the basis of each share by $60 ($6,000/100 shares) for the nonseparately computed income. Then B and C reduce the basis of each share by $120 ($12,000/100 shares) for the distribution. Finally, B and C decrease the basis of each share by $40 ($4,000/100 shares) for the separately stated deduction item.

(iii) The basis of the stock of B is reduced from $120 to $20 per share ($120 + $60 − $120 − $40). Prior to accounting for the separately stated deduction item, the basis of the stock of C is reduced from $80 to $20 ($80 + $60 − $120). Finally, because the period from January 1 through June 30, 2001 is treated under § 1.1377–1(b)(3)(i) as a separate taxable year for purposes of making adjustments to the basis of stock, under section 1366(d) and § 1.1366–2(a)(3), C may deduct only $20 per share of the remaining $40 of the separately stated deduction item, and the basis of the stock of C is reduced from $20 per share to $0 per share. Under section 1366 and § 1.1366–2(a)(3), C's remaining separately stated deduction item of $20 per share is treated as having been incurred in the first succeeding taxable year of Corporation S, which, for this purpose, begins on July 1, 2001.

(i) [Reserved]

(j) *Adjustments for items of income in respect of a decedent.* The basis determined under section 1014 of any stock in an S corporation is reduced by the portion of the value of the stock that is attributable to items constituting income in respect of a decedent. For the determination of items realized by an S corporation constituting income in respect of a decedent, see sections 1367(b)(4)(A) and 691 and applicable regulations thereunder. For the determination of the allowance of a deduction for the amount of estate tax attributable to income in respect of a decedent, see section 691(c) and applicable regulations thereunder.

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000; 65 FR 16319, Mar. 28, 2000; T.D. 9633, 78 FR 54168, Sept. 3, 2013; T.D. 9682, 79 FR 42678, July 23, 2014; T.D. 9759, 81 FR 17083, Mar. 28, 2016]

§ 1.1367–2 Adjustments to basis of indebtedness to shareholder.

(a) *In general*—(1) *Adjustments under section 1367.* This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness (including open account debt as described in paragraph (a)(2) of this section) of an S corporation to a shareholder. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section in accordance with the timing rules in paragraph (d) of this section.

(2) *Open Account Debt*—(i) *General rule*. The term *open account debt* means shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year. Advances and repayments on open account debt are treated as a single indebtedness.

(ii) *Exception*. If the shareholder advances not evidenced by a separate written instrument, net of repayments, exceeds an aggregate outstanding principal amount of $25,000 at the close of the S corporation's taxable year, for any subsequent taxable year the aggregate principal amount of that indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for purposes of this section. For any subsequent taxable year, that indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S corporation to a shareholder in this section.

(b) *Reduction in basis of indebtedness*—(1) *General rule*. If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2) (B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) *Termination of shareholder's interest in corporation during taxable year*. If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) *Multiple indebtedness*. If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) *Restoration of basis*—(1) *General rule*. If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any *net increase* in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, *net increase* with respect to a shareholder means the amount by which the shareholder's pro rata share of the items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

(2) *Multiple indebtedness.* If a shareholder holds more than one indebtedness (including any open account debt and any debt treated as a single indebtedness under paragraph (a)(2)(ii) of this section) as of the beginning of an S corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness (including any open account debt and any debt treated as a single indebtedness under paragraph (a)(2)(ii) of this section) in proportion to the amount that the basis of each outstanding indebtedness has been reduced under section 1367(b)(2)(A) and paragraph (b) of this section and not restored under section 1367(b)(2)(B) and this paragraph (c).

(d) *Time at which adjustments to basis of indebtedness are effective*—

(1) *In general.* The amounts of the adjustments to basis of indebtedness (including open account debt) provided in section 1367(b)(2) and this section are determined as of the close of the S corporation's taxable year, and the adjustments are generally effective as of the close of the S corporation's taxable year. However, if the shareholder is not a shareholder in the S corporation at that time, these adjustments are effective immediately before the shareholder terminates his or her interest in the S corporation. Except as provided in paragraph (d)(2) of this section, if a debt is disposed of or repaid in whole or in part before the close of the taxable year, the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the disposition or the first repayment on the debt during the taxable year. To the extent any indebtedness of the S corporation to the shareholder is disposed of or repaid (in whole or in part) during the taxable year and the shareholder's basis in that indebtedness has been reduced under paragraph (b) of this section and is not restored completely under paragraph (c) of this section, the disposition or repayment is a recognition event effective immediately before the indebtedness is disposed of or repaid (in whole or in part).

(2) *Open account debt*—(i) *In general.* All advances and repayments on open account debt (as described in paragraph (a)(2)(i) of this section) during the S corporation's taxable year are netted at the close of the S corporation's taxable year to determine the amount of any net advance or net repayment. The net advance or net repayment is combined with the outstanding aggregate principal balance of the existing open account debt and that amount is carried forward to the beginning of the subsequent taxable year as the outstanding aggregate principal amount of the open account debt (unless the aggregate principal amount meets the exception defined in paragraph (a)(2)(ii) of this section at the close of the taxable year). However, if the shareholder in the S corporation is not a shareholder of the S corporation at the close of the S corporation's taxable year, such advances and repayments on open account debt are netted, and the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the shareholder terminates his or her interest in the S corporation. If any open account debt is disposed of before or upon the close of the taxable year, the disposition is effective at the close of the S corporation's taxable year, and all advances and repayments are netted immediately prior to the disposition and the basis of that indebtedness is restored under paragraph (c) of this section, effective at the close of the S corporation's taxable year.

(ii) *Exception.* Shareholder indebtedness that is open account debt at the beginning of the taxable year but meets the exception defined in paragraph (a)(2)(ii) of this section at the close of the taxable year, adjustments to the basis of the indebtedness for that taxable year follow the provisions for open account debt. The resulting aggregate principal amount of indebtedness is treated as the principal amount of a debt evidenced by a separate written instrument for any subsequent taxable year, and is no longer subject to the open account debt provisions of this section.

(3) *Effect of election under section 1377(a)(2) or §1.1368–1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under §1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder either terminates his or her interest in the corporation or disposes of a substantial amount of stock, whichever the case may be.

(e) *Examples.* The following examples illustrate the principles of §1.1367–2. In each example, the corporation is a calendar year S corporation. The lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example 1. Reduction in basis of indebtedness. (i) A has been the sole shareholder in Corporation S since 1992. In 1993, A loans S $1,000 (Debt No. 1), which is evidenced by a ten-year promissory note in the face amount of $1,000. In 1996, A loans S $5,000 (Debt No. 2), which is evidenced by a demand promissory note. On December 31, 1996, the basis of A's stock is zero; the basis of Debt No. 1 has been reduced under paragraph (b) of this section to $0; and the basis of Debt No. 2 has been reduced to $1,000. On January 1, 1997, A loans S $4,000 (Debt No. 3), which is evidenced by a demand promissory note. For S's 1997 taxable year, the sum of the amounts specified in section 1367(a)(1) (in this case, nonseparately computed income and the excess deduction for depletion) is $6,000, and the sum of the amounts specified in section 1367(a)(2) (B), (D), and (E) (in this case, items of separately stated deductions and losses, noncapital, nondeductible expenses, and certain oil and gas depletion deductions—there is no nonseparately computed loss) is $10,000. Corporation S makes no payments to A on any of the loans during 1997.

(ii) The $4,000 excess of loss and deduction items is applied to reduce the basis of each indebtedness in proportion to the basis of that indebtedness over the aggregate bases of the indebtedness to the shareholder (determined immediately before any adjustment under section 1367(b)(2)(A) and paragraph (b) of this section is effective for the taxable year). Thus, the basis of Debt No. 2 is reduced in an amount equal to $800 ($4,000 (excess) × $1,000 (basis of Debt No. 2)/$5,000 (total basis of all debt)). Similarly, the basis in Debt No. 3 is reduced in an amount equal to $3,200 ($4,000 × $4,000/$5,000). Accordingly, on December 31, 1997, A's basis in his stock is zero and his bases in the three debts are as follows:

Debt	1/1/96 basis	12/31/96 reduction	1/1/97 basis	12/31/97 reduction	1/1/98 basis
No. 1 ..	$1,000	$1,000	$0	$0	$0
No. 2 ..	5,000	4,000	1,000	800	200
No. 3 ..	....	....	4,000	3,200	800

Example 2. Restoration of basis of indebtedness. (i) The facts are the same as in *Example 1*. On July 1, 1998, S completely repays Debt No. 3, and, for S's 1998 taxable year, the net increase (within the meaning of paragraph (c) of this section) with respect to A equals $4,500.

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals $9,000. Thus, the basis of Debt No. 3 is restored by $3,200 (the amount of the previous reduction) to $4,000. A's basis in Debt No. 3 is treated as restored immediately before that debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of $1,300 ($4,500 − $3,200) is applied to restore the bases of Debt No. 1 and Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is $5,800 ($9,000 − $3,200). The basis of Debt No. 1 is restored in an amount equal to $224 ($1,300 × $1,000/$5,800). Similarly, the basis in Debt No. 2 is restored in an amount equal to $1,076 ($1,300 × $4,800/$5,800). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

Original basis	Amount reduced	1/1/98 basis	Amount restored	12/31/98 basis
$1,000	$1,000	$0	$224	$224
5,000	4,800	200	1,076	1,276

Example 3. Full restoration of basis in indebtedness when debt is repaid in part during the taxable year. (i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S $1,000. S issues its note to C in the amount of $1,000, of which $950 is payable on March 1, 1998, and $50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares

of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to $900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is $300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under § 1.1367–2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or $1,000. Therefore, $100 of the $300 net increase is applied to restore the basis of the debt from $900 to $1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of $200 increases C's basis in her stock.

Example 4. Determination of net increase—distribution in excess of increase in basis. (i) D has been the sole shareholder in Corporation S since 1990. On January 1, 1996, D loans S $10,000 in return for a note from S in the amount of $10,000 of which $5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to $8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals $10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals $0. During 1998, S also makes distributions to D totaling $11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and must be taken into account for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The $10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the $11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to $0. See section 1368 and § 1.1368–1 (c) and (d) for the tax treatment of the $1,000 distribution in excess of D's basis.

Example 5. Distributions less than increase in basis. (i) The facts are the same as in *Example 4*, except that in 1998 S makes distributions to D totaling $8,000. On these facts, for 1998, there is a net increase with respect to D of $2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of $2,000 with respect to D for 1998, $2,000 of the $10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to $10,000 ($8,000 + $2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of $0 ($0 + $8,000 (increase in basis remaining after restoring basis in indebtedness)—$8,000 (distribution)) and a basis in the note of $10,000.

Example 6. The $25,000 aggregate principal amount applies to each shareholder. (i) A and B have been the two shareholders in Corporation S since 2000. As of the end of the 2008 taxable year, the bases of A's and B's stock are both zero. On June 1, 2009, A advances S $16,000, which is not evidenced by a written instrument. On August 1, 2009, B advances S $22,000, which is not evidenced by a written instrument. Both the $16,000 advance and the $22,000 advance are open account debt and remain outstanding at those amounts during 2009. There is no net increase under paragraph (c) of this section in year 2009.

(ii) At the close of the 2009 taxable year, A's open account debt does not exceed $25,000. A therefore carries forward to the beginning of the 2010 taxable year the $16,000 as open account debt.

(iii) At the close of the 2009 taxable year, B's open account debt does not exceed $25,000. B therefore carries forward to the beginning of the 2010 taxable year the $22,000 as open account debt.

Example 7. Treatment of open account debt. (i) The facts are the same as in *Example 6*, in addition to which, on December 31, 2009, A's basis in the open account debt is reduced under paragraph (b) of this section to $8,000. On April 1, 2010, S repays A $4,000 of the open account indebtedness. On September 1, 2010, A advances S an additional $1,000, which is not evidenced by a written instrument. There is no net increase under paragraph (c) of this section in year 2010.

(ii) The $4,000 April repayment S makes to A and A's $1,000 September advance are netted to result in a net repayment of $3,000 for the taxable year on A's $16,000 open account debt carried forward from 2009. Because there is no net increase in 2010, no basis of indebtedness is restored for the 2010 taxable year, and A realizes $1,500 of income on the $3,000 net repayment at the close of the 2010 taxable year.

(iii) At close of the 2010 taxable year, A's open account debt does not exceed $25,000. The net repayment of $3,000 for the taxable year on A's $16,000 open account debt carried forward from 2009, leaves A with an open account debt of $13,000 to carry forward as open account debt to the beginning of the 2011 taxable year.

Example 8. Treatment of shareholder indebtedness not evidenced by a written instrument which exceeds $25,000. (i) The facts are the same as in *Example 7*, in addition to which, on February 1, 2011, S repays $5,000 of the open account debt and on March 1, 2011, A advances S $20,000, which is not evidenced by a written instrument.

(ii) At the close of the 2010 taxable year, A has an open account debt of $13,000 to carry forward as open account debt to the beginning of the 2011 taxable year.

(iii) The 2011 advances and repayments are netted to result in a net advance of $15,000 on A's $13,000 open account debt carried forward from 2010, increasing A's open account debt to $28,000 as of the close of the 2011 taxable year. Because A's open account debt exceeds $25,000, for any subsequent taxable year the $28,000 indebtedness will be treated in the same manner as indebtedness evidenced by a separate written instrument for the purposes of this section. Because there is no net increase in 2011, no basis of indebtedness is restored for the 2011 taxable year.

[T.D. 8508, 59 FR 16, Jan. 3, 1994, as amended by T.D. 9428, 73 FR 62202, Oct. 20, 2008; T.D. 9428, 73 FR 67389, Nov. 14, 2008; T.D. 9428, 73 FR 71545, Nov. 25, 2008]

§ 1.1367–3 Effective/Applicability date.

Section 1.1367–2(a), (c)(2), (d)(2), and (e) *Example 6*, *Example 7*, and *Example 8* apply to any shareholder advances to the S corporation made on or after October 20, 2008 and repayments on those advances by the S corporation. The rules that apply with respect to shareholder advances to the S corporation made before October 20, 2008, are contained in § 1.1367–3 in effect prior to October 20, 2008. (See 26 CFR part 1 revised as of April 1, 2007.) Shareholders have the option to apply these rules to shareholder advances to the S corporation made before October 20, 2008, and repayments on those advances by the S corporation. Section 1.1367–1(h), *Example 5*(iii) applies on and after July 23, 2014. The rules that apply before July 23, 2014 are contained in § 1.1367–3 in effect prior to July 23, 2014 (see 26 CFR part 1 revised as of April 1, 2014).

[T.D. 9428, 73 FR 62203, Oct. 20, 2008, as amended by T.D. 9682, 79 FR 42678, July 23, 2014]

§ 1.1368–0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1368–1 through 1.1368–4.

(2) Liquidations and reorganizations.

(3) Corporate separations to which section 368(a)(1)(D) applies.

(e) Election to terminate year under section 1377(a)(2) or § 1.1368–1(g)(2).

§ 1.1368–3 Examples.

§ 1.1368–4 Effective date and transition rule.

[T.D. 8508, 59 FR 18, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996; T.D. 8852, 64 FR 71649, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368–1 Distributions by S corporations.

(a) *In general.* This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.

(b) *Date distribution made.* For purposes of section 1368, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.

(c) *S corporation with no earnings and profits.* A distribution made by an S corporation that has no accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(b).

(d) *S corporation with earnings and profits*—(1) *General treatment of distribution.* Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c). See section 316 and § 1.316–2 for provisions relating to the allocation of earnings and profits among distributions.

(2) *Previously taxed income.* This paragraph (d)(2) applies to distributions by a corporation that has both accumulated earnings and profits and previously taxed income (within the meaning of section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982, and the regulations thereunder) with respect to one or more shareholders. In the case of such a distribution, that portion remaining after the application of section 1368(c)(1) (relating to distributions from the accumulated adjustments account (AAA) as defined in § 1.1368–2(a)) is treated in the manner provided in section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a distribution of money and does not exceed the shareholder's net share immediately before the distribution of the corporation's previously taxed income. The AAA and the earnings and profits of the corporation are not decreased by that portion of the distribution. Any distribution remaining after the application of this paragraph (d)(2) is treated in the manner provided in section 1368(c) (2) and (3).

(e) *Certain adjustments taken into account*—(1) *Taxable years beginning before January 1, 1997.* For any taxable year of the corporation beginning before January 1, 1997, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367 (without regard to section 1367(a)(2)(A) (relating to decreases attributable to distributions not includible in income)) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under § 1.1368–2(a)(3)(iii)) for the S corporation's taxable year.

(2) *Taxable years beginning on or after August 18, 1998.* For any taxable year of the corporation beginning on or after August 18, 1998, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367(a)(1) (relating to increases in basis of stock) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under § 1.1368–2(a)(3)(iii)) for the S corporation's taxable year. Any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) for the taxable year shall not be taken into account.

(f) *Elections relating to source of distributions*—(1) *In general.* An S corporation may modify the application of paragraphs (c) and (d) of this section by electing (pursuant to paragraph (f)(5) of this section)—

(i) To distribute earnings and profits first as described in paragraph (f)(2) of this section;

(ii) To make a deemed dividend as described in paragraph (f)(3) of this section; or

(iii) To forego previously taxed income as described in paragraph (f)(4) of this section.

(2) *Election to distribute earnings and profits first*—(i) *In general.* An S corporation with accumulated earnings and profits may elect under this paragraph (f)(2) for any taxable year to distribute earnings and profits first as provided in section 1368(e)(3). Except as provided in paragraph (f)(2)(ii) of this section, distributions made by an S corporation making this election are treated as made first from earnings and profits under section 1368(c)(2) and second from the AAA under section 1368(c)(1). Any remaining portion of the distribution is treated in the manner provided in section 1368(b). This election is effective for all distributions made during the year for which the election is made.

(ii) *Previously taxed income.* If a corporation to which paragraph (d)(2) of this section (relating to corporations with previously taxed income) applies makes the election provided in this paragraph (f)(2) for the taxable year, and does not make the election to forego previously taxed income under paragraph (f)(4) of this section, distributions by the S corporation during the taxable year are treated as made first, from previously taxed income under paragraph (d)(2) of this section; second, from earnings and profits under section 1368(c)(2); and third, from the AAA under section 1368(c)(1). Any portion of a distribution remaining after the previously taxed income, earnings and profits, and the AAA are exhausted is treated in the manner provided in section 1368(b).

(iii) *Corporation with subchapter C and subchapter S earnings and profits.* If an S corporation that makes the election provided in this paragraph (f)(2) has both subchapter C earnings and profits (as defined in section 1362(d)(3)(B)) and subchapter S earnings and profits in a taxable year of the corporation in which the distribution is made, the distribution is treated as made first from subchapter C earnings and profits, and second from subchapter S earnings and profits. *Subchapter S earnings and profits* are earnings and profits accumulated in a taxable year beginning before January 1, 1983 (or in the case of a qualified casualty insurance electing small business corporation or a qualified oil corporation, earnings and profits accumulated in any taxable year), for which an election under subchapter S of chapter 1 of the Internal Revenue Code was in effect.

(3) *Election to make a deemed dividend.* An S corporation may elect under this paragraph (f)(3) to distribute all or part of its subchapter C earnings and profits through a deemed dividend. If an S corporation makes the election provided in this paragraph (f)(3), the S corporation will be considered to have made the election provided in paragraph (f)(2) of this section (relating to the election to distribute earnings and profits first). The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. The amount of the deemed dividend is considered, for all purposes of the Internal Revenue Code, as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

(4) *Election to forego previously taxed income.* An S corporation may elect to forego distributions of previously taxed income. If such an election is made, paragraph (d)(2) of this section (relating to corporations with previously taxed income) does not apply to any distribution made during the taxable year. Thus, distributions by a corporation that makes the election to forego

previously taxed income for a taxable year under this paragraph (f)(4) and does not make the election to distribute earnings and profits first under paragraph (f)(2) of this section are treated in the manner provided in section 1368(c) (relating to distributions by corporations with earnings and profits). Distributions by a corporation that makes both the election to distribute earnings and profits first under paragraph (f)(2) of this section and the election to forego previously taxed income under this paragraph (f)(4), are treated in the manner provided in paragraph (f)(2)(i) of this section.

(5) *Time and manner of making elections*—(i) *For earnings and profits.* If an election is made under paragraph (f)(2) of this section to distribute earnings and profits first, see section 1368(e)(3) regarding the consent required by shareholders.

(ii) *For previously taxed income and deemed dividends.* If an election is made to forego previously taxed income under paragraph (f)(4) of this section or to make a deemed dividend under paragraph (f)(3) of this section, consent by each ''affected shareholder,'' as defined in section 1368(e)(3)(B), is required.

(iii) *Corporate statement regarding elections.* A corporation makes an election for a taxable year under §1.1368–1(f) by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under section 6037 for that taxable year. In the statement, the corporation must identify the election it is making under §1.1368–1(f) and must state that each shareholder consents to the election. In the case of elections for taxable years beginning before January 1, 2003, an officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. In the case of elections for taxable years beginning after December 31, 2002, the statement described in this paragraph (f)(5)(iii) shall be verified by signing the return. A statement of election to make a deemed dividend under §1.1368–1(f) must include the amount of the deemed dividend that is distributed to each shareholder.

(iv) *Irrevocable elections.* The elections under this paragraph (f) are irrevocable and are effective only for the taxable year for which they are made. In applying the preceding sentence to elections under this paragraph (f), an election to terminate the taxable year under section 1377(a)(2) or §1.1368–1(g)(2) is disregarded.

(g) *Special rule*—(1) *Election to terminate year under §1.1368–1(g)(2).* If an election is made under paragraph (g)(2) of this section to terminate the year when there is a qualifying disposition, this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which there is a qualifying disposition of stock.

(2) *Election in case of a qualifying disposition*—(i) *In general.* In the case of a qualifying disposition, a corporation may elect under this paragraph (g)(2)(i) to treat the year as if it consisted of separate taxable years, the first of which ends at the close of the day on which the qualifying disposition occurs. A *qualifying disposition* is—

(A) A disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation's taxable year;

(B) A redemption treated as an exchange under section 302(a) or section 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation's taxable year; or

(C) An issuance of an amount of stock equal to or greater than 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation's taxable year.

(ii) *Effect of the election.* A corporation making an election under paragraph (g)(2)(i) of this section must treat the taxable year as separate taxable years for purposes of allocating items of income and loss; making adjustments to the AAA, earnings and profits, and basis; and determining the tax effect of distributions under section 1368 (b) and (c). An election made under paragraph (g)(2)(i) of this section may be made upon the occurrence of any qualifying disposition. Dispositions of stock that are taken into account as part of a qualifying disposition are not taken into account in determining whether a subsequent qualifying disposition has been made.

(iii) *Time and manner of making election.* A corporation makes an election under §1.1368–1(g)(2)(i) for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under section 6037 for a taxable year (without regard to the election under §1.1368–1(g)(2)(i)). In the statement, the corporation must state that it is electing for the taxable year under §1.1368–1(g)(2)(i) to treat the taxable year as if it consisted of separate taxable years. The corporation also must set forth facts in the statement relating to the qualifying disposition (*e.g.*, sale, gift, stock issuance, or redemption), and state that each shareholder who held stock in the corporation during the taxable year (without regard to the election under §1.1368–1(g)(2)(i)) consents to this election. For purposes of this election, a shareholder of the corporation for the taxable year is a shareholder as described in section 1362(a)(2). A single election statement may be filed for all elections made under §1.1368–1(g)(2)(i) for the taxable year. An election made under §1.1368–1(g)(2)(i) is irrevocable. In the case of elections for taxable years beginning before January 1, 2003, the statement through which a corporation makes an election under §1.1368–1(g)(2)(i) must be signed by an officer of the corporation under penalties of perjury. In the case of elections for taxable years beginning after December 31, 2002, the statement described in the preceding sentence shall be verified by signing the return.

(iv) *Coordination with election under section 1377(a)(2).* If the event resulting in a qualifying disposition also results in a termination of a shareholder's entire interest as described in §1.1377–1(b)(4), the election under this paragraph (g)(2) cannot be made. Rather, the election under section 1377(a)(2) and §1.1377–1(b) may be made. See §1.1377–1(b) (concerning the election under section 1377(a)(2)).

[T.D. 8508, 59 FR 19, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996; T.D. 8852, 64 FR 71650, Dec. 22, 1999; T.D. 9100, 68 FR 70706, Dec. 19, 2003; T.D. 9300, 71 FR 71043, Dec. 8, 2006]

§ 1.1368–2 Accumulated adjustments account (AAA).

(a) *Accumulated adjustments account*—(1) *In general.* The accumulated adjustments account is an account of the S corporation and is not apportioned among shareholders. The AAA is relevant for all taxable years beginning on or after January 1, 1983, for which the corporation is an S corporation. On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero. The AAA is increased in the manner provided in paragraph (a)(2) of this section and is decreased in the manner provided in paragraph (a)(3) of this section. For the adjustments to the AAA in the case of redemptions, liquidations, reorganizations, and corporate separations, see paragraph (d) of this section.

(2) *Increases to the AAA.* The AAA is increased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year:

(i) The items of income described in section 1366(a)(1)(A) other than income that is exempt from tax;

(ii) Any nonseparately computed income determined under section 1366(a)(1)(B); and

(iii) The excess of the deductions for depletion over the basis of property subject to depletion unless the property is an oil or gas property the basis of which has been allocated to shareholders under section 613A(c)(11).

(3) *Decreases to the AAA*—(i) *In general.* The AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year—

(A) The items of loss or deduction described in section 1366(a)(1)(A);

(B) Any nonseparately computed loss determined under section 1366(a)(1)(B);

(C) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account, other than—

(*1*) Federal taxes attributable to any taxable year in which the corporation was a C corporation; and

(*2*) Expenses related to income that is exempt from tax; and

(D) The sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation described in section 1367(a)(2)(E).

(ii) *Extent of allowable reduction.* The AAA may be decreased under paragraph (a)(3)(i) of this section below zero. The AAA is decreased by noncapital, nondeductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under §1.1367–1(g) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under section 1366(d)(1) or is otherwise not currently deductible under the Internal Revenue Code. However, in any subsequent taxable year in which the loss, deduction, or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or §1.1367–1(g) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

(iii) *Decrease to the AAA for distributions.* The AAA is decreased (but not below zero) by any portion of a distribution to which section 1368 (b) or (c)(1) applies.

(4) *Ordering rules for the AAA for taxable years beginning before January 1, 1997.* For any taxable year beginning before January 1, 1997, the adjustments to the AAA are made in the following order—

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3) of this section for the taxable year;

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section before it is decreased under paragraph (a)(3) (iii) of this section;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368 (b) or (c)(1) applies; and

(iv) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

(5) *Ordering rules for the AAA for taxable years beginning on or after August 18, 1998.* For any taxable year of the S corporation beginning on or after August 18, 1998, the adjustments to the AAA are made in the following order—

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3)(i) of this section for the taxable year;

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section (without taking into account any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) before it is decreased under paragraph (a)(3)(iii) of this section;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368(b) or (c)(1) applies;

(iv) The AAA is decreased by any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)); and

(v) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

(b) *Distributions in excess of the AAA*—(1) *In general.* A portion of the AAA (determined under paragraph (b)(2) of this section) is allocated to each of the distributions made for the taxable year if—

(i) An S corporation makes more than one distribution of property with respect to its stock during the taxable year of the corporation (including an S short year as defined under section 1362(e)(1)(A));

(ii) The AAA has a positive balance at the close of the year; and

(iii) The sum of the distributions made during the corporation's taxable year exceeds the balance of the AAA at the close of the year.

(2) Amount of the AAA allocated to each distribution. The amount of the AAA allocated to each distribution is determined by multiplying the balance of the AAA at the close of the current

taxable year by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the amount of all distributions made during the taxable year. For purposes of this paragraph (b)(2), the term *all distributions made during the taxable year* does not include any distribution treated as from earnings and profits or previously taxed income pursuant to an election made under section 1368(e)(3) and §1.1368–1(f)(2). See paragraph (d)(1) of this section for rules relating to the adjustments to the AAA for redemptions and distributions in the year of a redemption.

(c) *Distribution of money and loss property*—(1) *In general.* The amount of the AAA allocated to a distribution under this section must be further allocated (under paragraph (c)(2) of this section) if the distribution—

(i) Consists of property the adjusted basis of which exceeds its fair market value on the date of the distribution and money;

(ii) Is a distribution to which §1.1368–1(d)(1) applies; and

(iii) Exceeds the amount of the corporation's AAA properly allocable to that distribution.

(2) *Allocating the AAA to loss property.* The amount of the AAA allocated to the property other than money is equal to the amount of the AAA allocated to the distribution multiplied by a fraction, the numerator of which is the fair market value of the property other than money on the date of distribution and the denominator of which is the amount of the distribution. The amount of the AAA allocated to the money is equal to the amount of the AAA allocated to the distribution reduced by the amount of the AAA allocated to the property other than money.

(d) *Adjustment in the case of redemptions, liquidations, reorganizations, and divisions*—(1) *Redemptions*—(i) *General rule.* In the case of a redemption distribution by an S corporation that is treated as an exchange under section 302(a) or section 303(a) (a *redemption distribution*), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

(ii) *Special rule for years in which a corporation makes both ordinary and redemption distributions.* In any year in which a corporation makes one or more distributions to which section 1368(a) applies (*ordinary distributions*) and makes one or more redemption distributions, the AAA of the corporation is adjusted first for any ordinary distributions and then for any redemption distributions.

(iii) *Adjustments to earnings and profits.* Earnings and profits are adjusted under section 312 independently of any adjustments made to the AAA.

(2) *Liquidations and reorganizations.* An S corporation acquiring the assets of another S corporation in a transaction to which section 381(a) applies will succeed to and merge its AAA (whether positive or negative) with the AAA (whether positive or negative) of the distributor or transferor S corporation as of the close of the date of distribution or transfer. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior to the transaction.

(3) *Corporate separations to which section 368(a)(l)(D) applies.* If an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under section 312 (h). See §1.312–10(a).

(e) *Election to terminate year under section 1377(a)(2) or §1.1368–1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of termination of a shareholder's interest) or §1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder terminated his or her interest in the corporation or makes a substantial disposition of stock, whichever the case may be.

[T.D. 8508, 59 FR 20, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368–3 Examples.

The principles of §§ 1.1368–1 and 1.1368–2 are illustrated by the examples below. In each example Corporation S is a calendar year corporation:

Example 1. Distributions by S corporations without C corporation earnings and profits for taxable years beginning before January 1, 1997. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 1996, the first day of its 1996 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 1996, S makes a distribution of $38 to A. For S's 1996 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50 and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26.

(ii) Under section 1368(d)(1) and § 1.1368–1(e)(1), the adjustments to the bases of A's stock in S described in section 1367 are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $3.40 ($1 + [($50–$26) / 10 shares]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under § 1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution / 10 shares). However, A only has a basis of $3.40 in each share, and basis may not be reduced below zero. Therefore, the basis of each share of his stock is reduced by $3.40 to zero, and the remaining $4.00 of the distribution ([$3.80–$3.40] × 10 shares) is treated as gain from the sale or exchange of property. As of January 1, 1997, A has a basis of $0 in his shares of S stock.

Example 2. Distributions by S corporations without earnings and profits for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 2001, the first day of its 2001 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 2001, S makes a distribution of $38 to A. The balance in Corporation S's AAA is $100. For S's 2001 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50. A's pro rata share of the amount of the items described in sections 1367(a)(2)(B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26, $20 of which is attributable to items described in section 1367(a)(2)(B) and (C) and $6 of which is attributable to items described in section 1367(a)(2)(D) (relating to decreases in basis attributable to noncapital, nondeductible expenses).

(ii) Under section 1368(d)(1) and § 1.1368–1(e)(1) and (2), the adjustments to the basis of A's stock in S described in sections 1367(a)(1) are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $6.00 ($1 + [$50/10]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under § 1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution/10 shares). Thus, A's basis per share in the stock is $2.20 ($6.00–$3.80), after taking into account the distribution. Under section 1367(a)(2)(D), the basis of each share of A's stock in S after taking into account the distribution, $2.20, is decreased by $.60 ($6 noncapital, nondeductible expenses/10). Thus, A's basis per share after taking into account the nondeductible, noncapital expenses is $1.60. Under section 1367(a)(2)(B) and (C), A's basis per share is further decreased by $2 ($20 items described in section 1367(a)(2)(B) and (C)/10 shares). However, basis may not be reduced below zero. Therefore, the basis of each share of A's stock is reduced to zero. As of January 1, 2002, A has a basis of $0 in his shares of S stock. Pursuant to section 1366(d)(2), the $.40 of loss in excess of A's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to A.

Example 3. Distributions by S corporations with C corporation earnings and profits for taxable years beginning before January 1, 1997. (i) Corporation S properly elects to be an S corporation beginning January 1, 1997, and as of that date has accumulated earnings and profits of $30. B, an individual and sole shareholder of Corporation S, has 10 shares of S stock with a basis of $12 per share. In addition, B lends $30 to S evidenced by a demand note.

(ii) During 1997, S has a nonseparately computed loss of $150. S makes no distributions to B during 1997. Under section 1366(d)(1), B is allowed a loss equal to $150, the amount equal to the sum of B's bases in his shares of stock and his basis in the debt. Under section 1367, the loss reduces B's adjusted basis in his stock and debt to $0. Under §1.1368–2(a)(3), S's AAA as of December 31, 1997, has a deficit of $150 as a result of S's loss for the year.

(iii) For 1998, S has $220 of separately stated income and distributes $110 to B. The balance in the AAA (negative $150 from 1997) is increased by $220 for S's income for the year and decreased to $0 for the portion of the distribution that is treated as being from the AAA ($70). Under §1.1367–2(c), B's net increase is $150, determined by reducing the $220 of income by the $70 of the distribution not includible in income by B. Thus, B's basis in the debt is fully restored to $30, and B's basis in S stock (before accounting for the distribution) is increased from zero to $19 per share ([$220–$30 applied to the debt] / 10). Thirty dollars of the distribution is considered a dividend to the extent of S's $30 of earnings and profits, and the remaining $10 of the distribution reduces B's basis in the S stock. Thus, B's basis in the S stock as of December 31, 1998, is $11 per share ($19–[$70 AAA distribution / 10]–[10 distribution treated as a reduction in basis / 10]). The balance in the AAA is $0, S's earnings and profits are $0, and B's basis in the loan is $30.

Example 4. Distributions by S corporations with earnings and profits and no net negative adjustment for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $1,500 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $1,500. For the taxable year ending December 31, 2001, S does not have a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from $2,000 to $4,000 for the $2,000 of income earned during the 2001 taxable year. The AAA is decreased from $4,000 to $2,500 for the $1,500 of losses. The AAA is decreased from $2,500 to $1,000 for the portion of the distribution ($1,500) to B that does not exceed the AAA.

(iii) As of December 31, 2001, B's basis in his stock is $10 ($20 + $20 ($2,000 income/100 shares)—$15 ($1,500 distribution/100 shares)—$15 ($1,500 loss/100 shares).

Example 5. Distributions by S corporations with earnings and profits and net negative adjustment for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $2,000 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $3,500. For the taxable year ending December 31, 2001, S has a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from $2,000 to $4,000 for the $2,000 of income earned during the 2001 taxable year. Because under section 1368(e)(1)(C)(ii) and §1.1368–2(a)(ii), the net negative adjustment is not taken into account, the AAA is decreased from $4,000 to $2,000 for the portion of the losses ($2,000) that does not exceed the income earned during the 2001 taxable year. The AAA is reduced from $2,000 to zero for the portion of the distribution to B ($2,000) that does not exceed the AAA. The AAA is decreased from zero to a negative $1,500 for the portion of the $3,500 of loss that exceeds the $2,000 of income earned during the 2001 taxable year.

(iii) Under §1.1367–1(c)(1), the basis of a shareholder's share in an S corporation stock may not be reduced below zero. Accordingly, as of December 31, 2001, B's basis per share in his stock is zero ($20 + $20 income—$20 distribution—$35 loss). Pursuant to section 1366(d)(2), the $15 of loss in excess of B's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to B.

Example 6. Election in case of disposition of substantial amount of stock. (i) Corporation S, an S corporation, has earnings and profits of $3,000 and a balance in the AAA of $1,000 on January 1, 1997. C, an individual and the sole shareholder of Corporation S, has 100 shares of S stock with a basis of $10 per share. On July 3, 1997, C sells 50 shares of his S stock to D, an individual, for $250. For 1997, S has taxable income of $1,000, of which $500 was earned on or before July 3, 1997, and $500 earned after July 3, 1997. During its 1997 taxable year, S distributes $1,000 to C on February 1 and $1,000 to each of C and D on August 1. S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA. S makes the election under §1.1368–1(g)(2) to treat its taxable year as if it consisted of separate taxable years, the first of which ends at the close of July 3, 1997, the date of the qualifying disposition.

(ii) Under section §1.1368–1(g)(2), for the period ending on July 3, 1997, S's AAA is $500 ($1,000 (AAA as of January 1, 1997) + $500 (income earned from January 1, 1997 through July 3, 1997)–$1,000 (distribution made on February 1, 1997)). C's bases in his shares of stock is decreased to $5 per share ($10 (original basis) + $5 (increase per share for income)–$10 (decrease per share for distribution)).

(iii) The AAA is adjusted at the end of the taxable year for the period July 4 through December 31, 1997. It is increased from $500 (AAA as of the close of July 3, 1997) to $1,000 for the income earned during this period and is decreased by $1,000, the portion of the distribution ($2,000 in total) made to C and D on August 1 that does not exceed the AAA. The $1,000 portion of the distribution that remains after the AAA is reduced to zero is attributable to earnings and profits. Therefore C and D each have a dividend of $500, which does not affect their basis or S's AAA. The earnings and profits account is reduced from $3,000 to $2,000.

(iv) As of December 31, 1997, C and D have bases in their shares of stock of zero ($5 (basis as of July 4) + $5 ($500 income/100 shares)–$10 ($1,000 distribution/100 shares)). C and D each will report $500 as dividend income, which does not affect their basis or S's AAA.

Example 7. Election to distribute earnings and profits first. (i) Corporation S has been a calendar year C corporation since 1975. For 1982, S elects for the first time to be taxed under subchapter S, and during 1982 has $60 of earnings and profits. As of December 31, 1995, S has an AAA of $10 and earnings and profits of $160, consisting of $100 of subchapter C earnings and profits and $60 of subchapter S earnings and profits. For 1996, S has $200 of taxable income and the AAA is increased to $210 (before taking distributions into account). During 1996, S distributes $240 to its shareholders. With its 1996 tax return, S properly elects under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) Because S elected to distribute its earnings and profits before its AAA, the first $100 of the distribution is characterized as a distribution from subchapter C earnings and profits; the next $60 of the distribution is characterized as a distribution from subchapter S earnings and profits. Because $160 of the distribution is from earnings and profits, the shareholders of S have a $160 dividend. The remaining $80 of the distribution is a distribution from S's AAA and is treated by the shareholders as a return of capital or gain from the sale or exchange of property, as appropriate, under §1.1368–1(d)(1). S's AAA, as of December 31, 1996, equals $130 ($210–$80).

Example 8. Distributions in excess of the AAA. (i) On January 1, 1995, Corporation S has $40 of earnings and profits and a balance in the AAA of $100. S has two shareholders, E and F, each of whom own 50 shares of S's stock. For 1995, S has taxable income of $50, which increases the AAA to $150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $60 to each shareholder. On September 1, 1995, S distributes $30 to each shareholder. S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The sum of the distributions exceed S's AAA. Therefore, under §1.1368–2(b), a portion of S's $150 balance in the AAA as of December 31, 1995, is allocated to each of the February 1 and September 1 distributions based on the respective sizes of the distributions. Accordingly, S must allocate $100 ($150 (AAA) × ($120 (February 1 distribution)/$180 (the sum of the distributions))) of the AAA to the February 1 distribution, and $50 ($150 × ($60/$180)) to the September 1 distribution. The portions of the distributions to which the AAA is allocated are treated by the shareholder as a return of capital or gain from the sale or exchange of property, as appropriate. The remainder of the two distributions is treated as a dividend to the extent that it does not exceed S's earnings and profits. E and F must each report $10 of dividend income for the February 1 distribution. For the September 1 distribution, E and F must each report $5 of dividend income.

Example 9. Ordinary and redemption distributions in the same taxable year. (i) On January 1, 1995, Corporation S, an S corporation, has $20 of earnings and profits and a balance in the AAA of $10. S has two shareholders, G and H, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of $16, which increases the AAA to $26 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $10 to each shareholder. On December 31, 1995, S redeems for $13 all of shareholder G's stock in a redemption that is treated as a sale or exchange under section 302(a).

(ii) The sum of the ordinary distributions does not exceed S's AAA. Therefore, S must reduce the $26 balance in the AAA by $20 for the February 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or gain from the sale or exchange of property. S must adjust the remaining AAA, $6, in an amount equal to the ratable share of the remaining AAA attributable to the redeemed stock, or $3 (50% × $6).

(iii) S also must adjust the earnings and profits of $20 in an amount equal to the ratable share of the earnings and profits attributable to the redeemed stock. Therefore, S adjusts the earnings and profits by $10 (50% × $20), the ratable share of the earnings and profits attributable to the redeemed stock.

[T.D. 8508, 59 FR 22, Jan. 3, 1994; 59 FR 10675, Mar. 7, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999]

§ 1.1368–4 Effective date and transition rule.

Except for §§ 1.1368–1(e)(2), 1.1368–2(a)(5), and 1.1368–3 *Example 2*, *Example 4*, and *Example 5*, §§ 1.1368–1, 1.1368–2, and 1.1368–3 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1368–1(e)(2), § 1.1368–2(a)(5), and § 1.1368–3 *Example 2*, *Example 4*, and *Example 5* apply only to taxable years of the corporation beginning on or after August 18, 1998. For taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and legislative history. Except with regard to the deemed dividend rule under § 1.1368–1(f)(3), § 1.1368–1(e)(2), § 1.1368–2(a)(5), and § 1.1368–3 *Example 2*, *Example 4*, and *Example 5*, return positions consistent with §§ 1.1368–1, 1.1368–2, and 1.1368–3 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with §§ 1.1368–1(e)(2), 1.1368–2(a)(5), and 1.1368–3 *Example 2*, *Example 4*, and *Example 5* are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

[T.D. 8852, 64 FR 71651, Dec. 22, 1999]

§ 1.1374–0 Table of contents.

This section lists the major paragraph headings for §§ 1.1374–1 through 1.1374–10.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994, as amended by T.D. 9236, 70 FR 75731, Dec. 21, 2005]

§ 1.1374–1 General rules and definitions.

(a) *Computation of tax.* The tax imposed on the income of an S corporation by section 1374(a) for any taxable year during the recognition period is computed as follows—

(1) Step One: Determine the net recognized built-in gain of the corporation for the taxable year under section 1374(d)(2) and § 1.1374–2;

(2) Step Two: Reduce the net recognized built-in gain (but not below zero) by any net operating loss and capital loss carryforward allowed under section 1374(b)(2) and § 1.1374–5;

(3) Step Three: Compute a tentative tax by applying the rate of tax determined under section 1374(b)(1) for the taxable year to the amount determined under paragraph (a)(2) of this section;

(4) Step Four: Compute the final tax by reducing the tentative tax (but not below zero) by any credit allowed under section 1374(b)(3) and § 1.1374–6.

(b) *Anti-trafficking rules.* If section 382, 383, or 384 would have applied to limit the use of a corporation's recognized built-in loss or section 1374 attributes at the beginning of the first day of the recognition period if the corporation had remained a C corporation, these sections apply to limit their use in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

(c) *Section 1374 attributes.* Section 1374 attributes are the loss carryforwards allowed under section 1374(b)(2) as a deduction against net recognized built-in gain and the credit and credit carryforwards allowed under section 1374(b)(3) as a credit against the section 1374 tax.

(d) *Recognition period.* The recognition period is the 10-year (120-month) period beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets in a section 1374(d)(8) transaction. For example, if the first day of the recognition period is July 14, 1996, the last day of the recognition period is July 13, 2006. If the recognition period for certain assets ends during an S corporation's taxable year (for example, because the corporation was on a fiscal year as a C corporation and changed to a calendar year as an S corporation or because an S corporation acquired assets in a section 1374(d)(8) transaction during a taxable year), the S corporation must determine its pre-limitation amount (as defined in § 1.1374–2(a)(1)) for the year as if the corporation's books were closed at the end of the recognition period.

(e) *Predecessor corporation.* For purposes of section 1374(c)(1), if the basis of an asset of the S corporation is determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of another corporation, the other corporation is a predecessor corporation of the S corporation.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374–2 Net recognized built-in gain.

(a) *In general.* An S corporation's net recognized built-in gain for any taxable year is the least of—

(1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);

(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and

(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

(b) *Allocation rule.* If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.

(c) *Recognized built-in gain carryover.* If an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its taxable income limitation is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose, as determined under paragraph (b) of this section.

(d) *Accounting methods.* In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method(s) it uses for tax purposes as an S corporation.

(e) *Example.* The rules of this section are illustrated by the following example.

Example: Net recognized built-in gain. X is a calendar year C corporation that elects to become an S corporation on January 1, 1996. X has a net unrealized built-in gain of $50,000 and no net operating loss or capital loss carryforwards. In 1996, X has a pre-limitation amount of $20,000, consisting of ordinary income of $15,000 and capital gain of $5,000, a taxable income limitation of $9,600, and a net unrealized built-in gain limitation of $50,000. Therefore, X's net recognized built-in gain for 1996 is $9,600, because that is the least of the three amounts described in paragraph (a) of this section. Under paragraph (b) of this section, X's net recognized built-in gain consists of recognized built-in ordinary income of $7,200 [$15,000 × ($9,600/$20,000) = $7,200] and recognized built-in capital gain of $2,400 [$5,000 × ($9,600/$20,000) = $2,400]. Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of $10,400 ($20,000 − $9,600 = $10,400), consisting of $7,800 ($15,000 − $7,200 = $7,800) of recognized built-in ordinary income and $2,600 ($5,000 − $2,400 = $2,600) of recognized built-in capital gain.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374–3 Net unrealized built-in gain.

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Adjustment to net unrealized built-in gain*—(1) *In general.* If section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (b)(2) of this section, such net unrealized built-in gain is adjusted to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

(2) *Limitations on adjustment*—(i) *Recognized built-in gain or loss.* Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

(ii) *Anti-duplication rule.* Paragraph (b)(1) of this section shall not be applied to duplicate an adjustment to the net unrealized built-in gain for a pool of assets made pursuant to paragraph (b)(1) of this section.

(3) *Effect of adjustment.* Any adjustment to the net unrealized built-in gain made pursuant to this paragraph (b) only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the acquisition to which section 1374(d)(8) applies.

(4) *Pool of assets.* For purposes of this section, a pool of assets means—

(i) The assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or

(ii) The assets the S corporation acquired from a C corporation in a section 1374(d)(8) transaction.

(c) *Examples.* The following examples illustrate the rules of this section:

Example 1. Computation of net unrealized built-in gain. (i)(A) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000

Liabilities	Amount
Mortgage	$200,000
Accounts Payable	100,000
Total	300,000

(B) Further, X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be $1,050,000 ($750,000 cash received + $300,000 liabilities assumed = $1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized	$1,050,000
Deduction allowed (A/P)	(100,000)
Basis of X's assets	(900,000)
Section 481 adjustments	60,000
Net unrealized built-in gain	110,000

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $33,000 and an adjusted basis of $18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has $10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is $50,000. Effective June 1, 2009, X elects under section 1361 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by $15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $0.

(iii) Under §1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $10,000, X's taxable income limitation is $50,000, and X's net unrealized built-in gain limitation is $0. Because the net unrealized built-in gain of the first pool of assets has been adjusted to $0, despite the $10,000 of recognized built-in gain in 2009, X has $0 net recognized built-in gain for the taxable year ending on December 31, 2009.

Example 3. Adjustment to net unrealized built-in gain for built-in loss in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of negative $5,000.

Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of $18,000 and an adjusted basis of $33,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, resulting in $8,000 of recognized built-in gain. X has had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is $50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the reorganization. The net unrealized built-in gain of the first pool of assets, therefore, is increased by $15,000, the amount by which the adjusted basis of the Y stock exceeded its fair market value as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $10,000.

(iii) Under §1.1374–2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is $8,000 and X's taxable income limitation is $50,000. The net unrealized built-in gain of the first pool of assets has been adjusted to $10,000, so X's net unrealized built-in gain limitation is $10,000. X, therefore, has $8,000 net recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is $2,000.

Example 4. Adjustment to net unrealized built-in gain in case of prior gain recognition. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $30,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $45,000 and an adjusted basis of $10,000. Y has no current or accumulated earnings and profits. On April 1, 2007, Y distributes $18,000 to X, $8,000 of which is treated as gain to X from the sale or exchange of property under section 301(c)(3). That $8,000 is recognized built-in gain to X under section 1374(d)(3), and results in $8,000 of net recognized built-in gain to X for 2007. X's net unrealized built-in gain limitation for 2008 is $22,000. On June 1, 2009, Y transfers its assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of that pool of assets, however, can only be adjusted to reflect the amount of built-in gain that was inherent in the Y stock on January 1, 2005 that has not resulted in recognized built-in gain during the recognition period. In this case, therefore, the net unrealized built-in gain of the first pool of assets cannot be reduced by more than $27,000 ($35,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005, minus $8,000, the recognized built-in gain with respect to the stock during the recognition period). Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $3,000. The net unrealized built-in gain limitation for 2009 is $0.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994, as amended by T.D. 9180, 70 FR 8728, Feb. 23, 2005]

§ 1.1374–4 Recognized built-in gain or loss.

(a) *Sales and exchanges*—(1) *In general.* Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property.* For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

(3) *Examples.* The rules of this paragraph (a) are illustrated by the following examples.

Example 1. Production and sale of oil. X is a C corporation that purchased a working interest in an oil and gas property for $100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of $250,000 and an adjusted basis of $50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for $75,000, and includes that amount in gross income. Under paragraph (a)(1) of this section, the $75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

Example 2. Sale of oil and gas property. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own 50 percent of Y's stock. In addition, Y owns a royalty interest in an oil and gas property with a fair market value of $300,000 and an adjusted basis of $200,000. Under section 613A(c)(11)(B), Y's $200,000 adjusted basis in the royalty interest is allocated $100,000 to A and $100,000 to B. During 1996, A and B take depletion deductions with respect to the royalty interest of $10,000 and $15,000, respectively. As of January 1, 1997, A and B have a basis in the royalty interest of $90,000 and $85,000, respectively. On January 1, 1997, Y sells the royalty interest for $250,000. Under paragraph (a)(1) of this section, Y has gain recognized and recognized built-in gain of $75,000 ($250,000 − ($90,000 + $85,000) = $75,000) on the sale.

(b) *Accrual method rule*—(1) *Income items.* Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

(2) *Deduction items.* Except as otherwise provided in this section, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation). In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461–4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

(3) *Examples.* The rules of this paragraph (b) are illustrated by the following examples.

Example 1. Accounts receivable. X is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. On January 1, 1996, X has $50,000 of accounts receivable for services rendered before that date. On that date, the accounts receivable have a fair market value of $40,000 and an adjusted basis of $0. In 1996, X collects $50,000 on the accounts receivable and includes that amount in gross income. Under paragraph (b)(1) of this section, the $50,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period if X had been an accrual method taxpayer. However, if X instead disposes of the accounts receivable for $45,000 on July 1, 1996, in a transaction treated as a sale or exchange for Federal income tax purposes, X would have recognized built-in gain of $40,000 on the disposition.

Example 2. Contingent liability. Y is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. In 1995, a lawsuit was filed against Y claiming $1,000,000 in damages. In 1996, Y loses the lawsuit, pays a $500,000 judgment, and properly claims a deduction for that amount. Under paragraph (b)(2) of this section, the $500,000 deduction allowed in 1996 is not recognized built-in loss because it would not have been allowed as a deduction against gross income before the beginning of the recognition period if Y had been an accrual method taxpayer (even disregarding section 461(h)(2)(C) and § 1.461–4(g)).

Example 3. Deferred payment liabilities. X is a C corporation using the cash method that elects to become an S corporation on January 1, 1996. In 1995, X lost a lawsuit and became obligated to pay $150,000 in damages. Under section 461(h)(2)(C), this amount is not allowed as a deduction until X makes payment. In 1996, X makes payment and properly claims a deduction for the amount of the payment. Under paragraph (b)(2) of this section, the $150,000 deduction allowed in 1996 is recognized built-in loss because it would have been allowed as a deduction against gross income before the beginning of the recognition period if X had been an accrual method taxpayer (disregarding section 461(h)(2)(C) and § 1.461–4(g)).

Example 4. Deferred prepayment income. Y is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, Y received $2,500 for services to be rendered in 1996, and properly elected to include the $2,500 in gross income in 1996 under Rev. Proc. 71–21, 1971–2 C.B. 549 (see § 601.601(d)(2)(ii)(*b*) of this chapter). Under paragraph (b)(1) of this section, the $2,500 included in gross income in 1996 is not recognized built-in gain because it would not have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that Y actually used before the beginning of the recognition period.

Example 5. Change in method. X is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, X received $5,000 for services to be rendered in 1996, and properly included the $5,000 in gross income. In 1996, X properly elects to include the $5,000 in gross income in 1996 under Rev. Proc. 71–21, 1971–2 C.B. 549 (see § 601.601(d)(2)(ii)(*b*) of this chapter). As a result of the change in method of accounting, X has a $5,000 negative section 481(a) adjustment. Under paragraph (b)(1) of this section, the $5,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that X actually used before the beginning of the recognition period. In addition, the $5,000 negative section 481(a) adjustment is recognized built-in loss because it relates to an item (the $5,000 X received for services in 1995) attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. See paragraph (d) of this section for rules regarding section 481(a) adjustments.

(c) *Section 267(a)(2) and 404(a)(5) deductions*—(1) *Section 267(a)(2).* Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is paid—

(A) In the first two and one-half months of the recognition period; or

(B) To a related party owning, under the attribution rules of section 267, less than 5 percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

(2) *Section 404(a)(5).* Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 404(a)(5), relating to payments for deferred compensation, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is not paid to a related party to which section 267(a)(2) applies.

(3) *Examples.* The rules of this paragraph (c) are illustrated by the following examples.

Example 1. Fixed annuity. X is a C corporation that elects to become an S corporation effective January 1, 1996. On December 31, 1995, A is age 60, has provided services to X as an employee for 20 years, and is a vested participant in X's unfunded nonqualified retirement plan. Under the plan, A receives $1,000 per month upon retirement until death. The plan provides no additional benefits. A retires on December 31, 1997, after working for X for 22 years. A at no time is a shareholder of X. X's deductions under section 404(a)(5) in the recognition period on paying A the $1,000 per month are recognized built-in loss because all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period.

Example 2. Increase in annuity for working beyond 20 years. The facts are the same as *Example 1,* except that under the plan A receives $1,000 per month, plus $100 per month for each year A works for X beyond 20 years, upon retirement until death. X's deductions on paying A the $1,000 per month are recognized built-in loss. However, X's deductions on paying A the $200 per month for the two years A worked for X beyond 20 years are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

Example 3. Cost of living adjustment. The facts are the same as *Example 1,* except that under the plan A receives $1,000 per month, plus annual cost of living adjustments, upon retirement until death. X's deductions under section 404(a)(5) on paying A the $1,000 per month are recognized built-in loss. However, X's deductions under section 404(a)(5) on paying A the annual cost of living adjustment are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

(d) *Section 481(a) adjustments*—(1) *In general.* Any section 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. The principles for determining recognized built-in gain or loss in this section include, for example, the accrual method rule under paragraph (b) of this section.

(2) *Examples.* The rules of this paragraph (d) are illustrated by the following examples.

Example 1. Omitted item attributable to prerecognition period. X is a C corporation that elects to become an S corporation effective January 1, 1996. X improperly capitalizes repair costs and recovers the costs through depreciation of the related assets. In 1999, X properly changes to deducting repair costs as they are incurred. Under section 481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. In addition, X has a negative section 481(a) adjustment equal to the basis reduction. Under paragraph (d)(1) of this section, the portion of X's negative section 481(a) adjustment relating to the repair costs incurred before the recognition period is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

Example 2. Duplicated item attributable to prerecognition period. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y improperly uses an accrual method without regard to the economic performance rules of section 461(h) to account for worker's compensation claims. As a result, Y takes deductions when claims are filed. In 1999, Y properly changes to an accrual method with regard to the economic performance rules under section 461(h)(2)(C) for worker's compensation claims. As a result, Y takes deductions when claims are paid. The positive section 481(a) adjustment resulting from the change is equal to the amount of claims filed, but unpaid, before the year of change. Under paragraph (b)(2) of this section, the deduction allowed in the recognition period for claims filed, but unpaid, before the recognition period is recognized built-in loss because a deduction was allowed for those claims before the recognition period under an accrual method without regard to section 461(h)(2)(C). Under paragraph (d)(1) of this section, the portion of Y's positive section 481(a) adjustment relating to claims filed, but unpaid, before the recognition period is recognized built-in gain because those claims are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

(e) *Section 995(b)(2) deemed distributions.* Any item of income properly taken into account during the recognition period under section 995(b)(2) is recognized built-in gain if the item results from a DISC termination or disqualification occurring before the beginning of the recognition period.

(f) *Discharge of indebtedness and bad debts.* Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under section 61(a)(12) or as a bad debt deduction under section 166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

(g) *Completion of contract.* Any item of income properly taken into account during the recognition period under the completed contract method (as described in § 1.460–4(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method (as described in § 1.460–4(b)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.

(h) *Installment method*—(1) *In general.* If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.

(2) *Limitation on amount subject to tax.* For purposes of paragraph (h)(1) of this section, the taxable income limitation under § 1.1374–2(a)(2) is equal to the amount by which the S corporation's net recognized built-in gain would have been increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from

the sale had been reported in the year of the sale and all provisions of section 1374 applied. For purposes of the preceding sentence, if the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.

(3) *Rollover rule.* If the limitation in paragraph (h)(2) of this section applies, the excess of the amount reported under the installment method over the amount subject to tax under the limitation is treated as if it were reported in the succeeding taxable year(s), but only for succeeding taxable year(s) in the recognition period. The amount reported in the succeeding taxable year(s) under the preceding sentence is reduced to the extent that the amount not subject to tax under the limitation in paragraph (h)(2) of this section was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

(4) *Use of losses and section 1374 attributes.* If income is reported under the installment method by an S corporation for a taxable year after the recognition period and the income is subject to tax under paragraph (h)(1) of this section, the S corporation's section 1374 attributes may be used to the extent their use is allowed under all applicable provisions of the Code in determining the section 1374 tax. However, the S corporation's loss recognized for a taxable year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the section 1374 tax.

(5) *Examples.* The rules of this paragraph (h) are illustrated by the following examples.

Example 1. Rollover rule. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X sells Blackacre with a basis of $0 and a value of $100,000 in exchange for a $100,000 note bearing a market rate of interest payable on January 1, 2001. X does not make the election under section 453(d) and, therefore, reports the $100,000 gain using the installment method under section 453. In the year 2001, X has income of $100,000 on collecting the note, unexpired C year attributes of $0, recognized built-in loss of $0, current losses of $100,000, and taxable income of $0. If X had reported the $100,000 gain in 1996, X's net recognized built-in gain from 1996 through 2001 would have been $75,000 greater than otherwise. Under paragraph (h) of this section, X has $75,000 net recognized built-in gain subject to tax under section 1374. X also must treat the $25,000 excess of the amount reported, $100,000, over the amount subject to tax, $75,000, as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent X establishes that the $25,000 was not subject to tax under section 1374 in the year 2001 because X had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

Example 2. Use of losses. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Y sells Whiteacre with a basis of $0 and a value of $250,000 in exchange for a $250,000 note bearing a market rate of interest payable on January 1, 2006. Y does not make the election under section 453(d) and, therefore, reports the $250,000 gain using the installment method under section 453. In the year 2006, Y has income of $250,000 on collecting the note, unexpired C year attributes of $0, loss of $100,000 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of $150,000, and taxable income of $0. If Y had reported the $250,000 gain in 1996, X's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been $225,000 greater than otherwise. Under paragraph (h) of this section, X has $225,000 net recognized built-in gain subject to tax under section 1374.

Example 3. Use of section 1374 attribute. Z is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Z sells Greenacre with a basis of $0 and a value of $500,000 in exchange for a $500,000 note bearing a market rate of interest payable on January 1, 2011. Z does not make the election under section 453(d) and, therefore, reports the $500,000 gain using the installment method under section 453. In the year 2011, Z has income of $500,000 on collecting the note, loss of $0 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of $0, taxable income of $500,000, and a minimum tax credit of $60,000 arising in 1995. None of Z's minimum tax credit is limited under sections 53(c) or 383. If Z had reported the $500,000 gain in 1996, Z's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been $350,000 greater than otherwise. Under paragraph (h) of this section, Z has $350,000 net recognized built-in gain subject to tax under section 1374, a tentative section 1374 tax of $122,500 ($350,000 × .35 = $122,500), and a section 1374 tax after using its minimum tax credit arising in 1995 of $62,250 ($122,500 − $60,000 = $62,250).

(i) *Partnership interests*—(1) *In general.* If an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which section 1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows—

(i) Step One: Apply the rules of section 1374(d) to the S corporation's distributive share of partnership items of income, gain, loss, or deduction included in income or allowed as a deduction under the rules of subchapter K to determine the extent to which it would have been treated as recognized built-in gain or loss if the partnership items had originated in and been taken into account directly by the S corporation (partnership 1374 items);

(ii) Step Two: Determine the S corporation's net recognized built-in gain without partnership 1374 items;

(iii) Step Three: Determine the S corporation's net recognized built-in gain with partnership 1374 items; and

(iv) Step Four: If the amount computed under Step Three (paragraph (i)(1)(iii) of this section) exceeds the amount computed under Step Two (paragraph (i)(1)(ii) of this section), the excess (as limited by paragraph (i)(2)(i) of this section) is the S corporation's partnership RBIG, and the S corporation's net recognized built-in gain is the sum of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) plus the partnership RBIG. If the amount computed under Step Two (paragraph (i)(1)(ii) of this section) exceeds the amount computed under Step Three (paragraph (i)(1)(iii) of this section), the excess (as limited by paragraph (i)(2)(ii) of this section) is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) after subtracting the partnership RBIL.

(2) *Limitations*—(i) *Partnership RBIG.* An S corporation's partnership RBIG for any taxable year may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG for prior taxable years. The preceding sentence does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(ii) *Partnership RBIL.* An S corporation's partnership RBIL for any taxable year may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL for prior taxable years.

(3) *Disposition of partnership interest.* If an S corporation disposes of its partnership interest, the amount that may be treated as recognized built-in gain may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG during the recognition period. Similarly, the amount that may be treated as recognized built-in loss may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL during the recognition period.

(4) *RBIG and RBIL limitations*—(i) *Sale of partnership interest.* An S corporation's RBIG or RBIL limitation is the total of the following—

(A) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party; decreased by

(B) The corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section; and increased or decreased by

(C) The corporation's allocable share of the partnership's section 481(a) adjustments at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section.

(ii) *Amounts of limitations.* If the result in paragraph (i)(4)(i) of this section is a positive amount, the S corporation has a RBIG limitation equal to that amount and a RBIL limitation of $0, but if the result in paragraph (i)(4)(i) of this section is a negative amount, the S corporation has a RBIL limitation equal to that amount and a RBIG limitation of $0.

(5) *Small interest exception*—(i) *In general.* Paragraph (i)(1) of this section does not apply to a taxable year in the recognition period if the S corporation's partnership interest represents less than 10 percent of the partnership's capital and profits at all times during the taxable year and prior taxable years in the recognition period, and the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is less than $100,000.

(ii) *Contributed assets.* For purposes of paragraph (i)(5)(i) of this section, if the S corporation contributes any assets to the partnership during the recognition period and the S corporation held the assets as of the beginning of the recognition period, the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is determined as if the assets were contributed to the partnership before the beginning of the recognition period (using the fair market value of each contributed asset as of the beginning of the recognition period). The contribution does not affect whether paragraph (i)(5)(i) of this section applies for taxable years in the recognition period before the taxable year in which the contribution was made.

(iii) *Anti-abuse rule.* Paragraph (i)(5)(i) of this section does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(6) *Section 704(c) gain or loss.* Solely for purposes of section 1374, an S corporation's section 704(c) gain or loss amount with respect to any asset is not reduced during the recognition period, except for amounts treated as recognized built-in gain or loss with respect to that asset under this paragraph.

(7) *Disposition of distributed partnership asset.* If on the first day of the recognition period an S corporation holds an interest in a partnership that holds an asset and during the recognition period the partnership distributes the asset to the S corporation that thereafter disposes of the asset, the asset is treated as having been held by the S corporation on the first day of the recognition period and as having the fair market value and adjusted basis in the hands of the S corporation that it had in the hands of the partnership on that day.

(8) *Examples.* The rules of this paragraph (i) are illustrated by the following examples.

Example 1. Pre-conversion partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $25,000 and a value of $45,000. In 1996, P buys Whiteacre for $50,000. In 1999, P sells Blackacre for $55,000 and recognizes a gain of $30,000 of which $15,000 is included in X's distributive share. P also sells Whiteacre in 1999 for $42,000 and recognizes a loss of $8,000 of which $4,000 is included in X's distributive share. Under this paragraph and section 1374(d)(3), X's $15,000 gain is presumed to be recognized built-in gain and thus treated as a partnership 1374 item, but this presumption is rebutted if X establishes that P's gain would have been only $20,000 ($45,000 − $25,000 = $20,000) if Blackacre had been sold on the first day of the recognition period. In such a case, only X's distributive share of the $20,000 built-in gain, $10,000, would be treated as a partnership 1374 item. Under this paragraph and section 1374(d)(4), X's $4,000 loss is not treated as a partnership 1374 item because P did not hold Whiteacre on the first day of the recognition period.

Example 2. Post-conversion contribution. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns (among other assets) Blackacre with a basis of $100,000 and a value of $200,000. On January 1, 1998, when Blackacre has a basis of $100,000 and a value of $200,000, Y contributes Blackacre to partnership P for a 50 percent interest in P. On January 1, 2000, P sells Blackacre for $300,000 and recognizes a gain of $200,000 on the sale ($300,000 − $100,000 = $200,000). P is allocated $100,000 of the gain under section 704(c), and another $50,000 of the gain for its fifty percent share of the remainder, for a total of $150,000. Under this paragraph and section 1374(d)(3), if Y establishes that P's gain would have been only $100,000 ($200,000 − $100,000 = $100,000) if

Blackacre had been sold on the first day of the recognition period, Y would treat only $100,000 as a partnership 1374 item.

Example 3. RBIG limitation of $100,000 or $50,000. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $100,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $50,000 and a value of $200,000. In 1996, P sells Blackacre for $200,000 and recognizes a gain of $150,000 of which $75,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $35,000 and with partnership 1374 items is $110,000. Thus, X has a partnership RBIG of $75,000 except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $100,000, X's partnership RBIG of $75,000 is not limited and X's net recognized built-in gain for the year is $110,000 ($35,000 + $75,000 = $110,000). However, if X had a RBIG limitation of $50,000 instead of $100,000, X's partnership RBIG would be limited to $50,000 under paragraph (i)(2)(i) of this section and X's net recognized built-in gain would be $85,000 ($35,000 + $50,000 = $85,000).

Example 4. RBIL limitation of $60,000 or $40,000. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns a 50 percent interest in partnership P with a RBIG limitation of $0 and a RBIL limitation of $60,000. P owns (among other assets) Blackacre with a basis of $225,000 and a value of $125,000. In 1996, P sells Blackacre for $125,000 and recognizes a loss of $100,000 of which $50,000 is included in Y's distributive share and treated as a partnership 1374 item. Y's net recognized built-in gain for 1996 computed without partnership 1374 items is $75,000 and with partnership 1374 items is $25,000. Thus, Y has a partnership RBIL of $50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is $60,000, Y's partnership RBIL for the year is not limited and Y's net recognized built-in gain for the year is $25,000 ($75,000 − $50,000 = $25,000). However, if Y had a RBIL limitation of $40,000 instead of $60,000, Y's partnership RBIL would be limited to $40,000 under paragraph (i)(2)(ii) of this section and Y's net recognized built-in gain for the year would be $35,000 ($75,000 − $40,000 = $35,000).

Example 5. RBIG limitation of $0. (i) X is a C corporation that elects to become an S corporation on January 1, 1996. X owns a 50 percent interest in partnership P with a RBIG limitation of $0 and a RBIL limitation of $25,000.

(a) In 1996, P's partnership 1374 items are—

(1) Ordinary income of $25,000; and

(2) Capital gain of $75,000.

(b) X itself has—

(1) Recognized built-in ordinary income of $40,000; and

(2) Recognized built-in capital loss of $90,000.

(ii) X's net recognized built-in gain for 1996 computed without partnership 1374 items is $40,000 and with partnership 1374 items is $65,000 ($40,000 + $25,000 = $65,000). Thus, X's partnership RBIG is $25,000 for the year except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is $0, X's partnership RBIG of $25,000 is limited to $0 and X's net recognized built-in gain for the year is $40,000.

Example 6. RBIL limitation of $0. (i) Y is a C corporation that elects to become an S corporation on January 1, 1996. Y owns a 50 percent interest in partnership P with a RBIG limitation of $60,000 and a RBIL limitation of $0.

(a) In 1996, P's partnership 1374 items are—

(1) Ordinary income of $25,000; and

(2) Capital loss of $90,000.

(b) Y itself has—

(1) recognized built-in ordinary income of $40,000; and

(2) recognized built-in capital gain of $75,000.

(ii) Y's net recognized built-in gain for 1996 computed without partnership 1374 items is $115,000 ($40,000 + $75,000 = $115,000) and with partnership 1374 items is $65,000 ($40,000 + $25,000 = $65,000). Thus, Y's partnership RBIL is $50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is $0, Y's partnership RBIL of $50,000 is limited to $0 and Y's net recognized built-in gain is $115,000.

Example 7. Disposition of partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of $200,000 and a RBIL limitation of $0. P owns (among other assets) Blackacre with a basis of $20,000 and a value of $140,000. In 1996, P sells Blackacre for $140,000 and recognizes a gain of $120,000 of which $60,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is $95,000 and with partnership 1374 items is $155,000. Thus, X has a partnership RBIG of $60,000. In 1999, X sells its entire interest in P for $350,000 and recognizes a gain of $250,000. Under paragraph (i)(3) of this section, X's recognized built-in gain on the sale is limited by its RBIG limitation to $140,000 ($200,000 − $60,000 = $140,000).

Example 8. Section 704(c) case. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y contributes Asset 1, 5-year property with a value of $40,000 and a basis of $0, and an unrelated party contributes $40,000 in cash, each for a 50 percent interest in partnership P. The partnership adopts the traditional method under § 1.704–3(b). If P sold Asset 1 for $40,000 immediately after it was contributed by Y, P's $40,000 gain would be allocated to Y under section 704(c). Instead, Asset 1 is sold by P in 1999 for $36,000 and P recognizes gain of $36,000 ($36,000 − $0 = $36,000) on the sale. However, because book depreciation of $8,000 per year has been taken on Asset 1 in 1996, 1997, and 1998, Y is allocated only $16,000 of P's $36,000 gain ($40,000 − (3 × $8,000) = ($16,000 − $0) = $16,000) under section 704(c). The remaining $20,000 of P's $36,000 gain ($36,000 − $16,000 = $20,000) is allocated 50 percent to each partner under section 704(b). Thus, a total of $26,000 ($16,000 + $10,000 = $26,000) of P's $36,000 gain is allocated to Y. However, under paragraph (i)(6) of this section, Y treats $36,000 as a partnership 1374 item on P's sale of Asset 1.

Example 9. Disposition of distributed partnership asset. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a fifty percent interest in partnership P and P owns (among other assets) Blackacre with a basis of $20,000 and a value of $40,000. On January 1, 1998, P distributes Blackacre to X, when Blackacre has a basis of $20,000 and a value of $50,000. Under section 732(a)(1), X has a transferred basis of $20,000 in Blackacre. On January 1, 1999, X sells Blackacre for $60,000 and recognizes a gain of $40,000. Under paragraph (i)(7) of this section and section 1374(d)(3), X has recognized built-in gain from the sale of $20,000, the amount of built-in gain in Blackacre on the first day of the recognition period.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994, as amended by T.D. 8995. 67 FR 34610, May 15, 2002]

§ 1.1374–5 Loss carryforwards.

(a) *In general.* The loss carryforwards allowed as deductions against net recognized built-in gain under section 1374(b)(2) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other loss carryforwards, such as charitable contribution carryforwards under section 170(d)(2), are not allowed as deductions against net recognized built-in gain.

(b) *Example.* The rules of this section are illustrated by the following example.

Example: Section 382 limitation. X is a C corporation that has an ownership change under section 382(g)(1) on January 1, 1994. On that date, X has a fair market value of $500,000, NOL carryforwards of $400,000, and a net unrealized built-in gain under section 382(h)(3)(A) of $0. Assume X's section 382 limitation under section 382(b)(1) is $40,000. X elects to become an S corporation on January 1, 1998. On that date, X has NOL carryforwards of $240,000 (having used $160,000 of its pre-change net operating losses in its 4 preceding taxable years) and a section 1374 net unrealized built-in gain of $250,000. In 1998, X has net recognized built-in gain of $100,000. X may use $40,000 of its NOL carryforwards as a deduction against its $100,000 net recognized built-in gain, because X's section 382 limitation is $40,000.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–6 Credits and credit carryforwards.

(a) *In general.* The credits and credit carryforwards allowed as credits against the section 1374 tax under section 1374(b)(3) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other credits or credit carryforwards, such as foreign tax credits under section 901, are not allowed as credits against the section 1374 tax.

(b) *Limitations.* The amount of business credit carryforwards and minimum tax credit allowed against the section 1374 tax are subject to the limitations described in section 38(c) and section 53(c), respectively, as modified by this paragraph. The tentative tax determined under paragraph (a)(3) of § 1.1374–1 is treated as the regular tax liability described in sections 38(c)(1) and 53(c)(1), and as the net income tax and net regular tax liability described in section 38(c)(1). The tentative minimum tax described in section 55(b) is determined using the rate of tax applicable to corporations and without regard to any alternative minimum tax foreign tax credit described in that section and by treating the net recognized built-in gain determined under § 1.1374–2, modified to take into account the adjustments of sections 56 and 58 applicable to corporations and the preferences of section 57, as the alternative minimum taxable income described in section 55(b)(2).

(c) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. Business credit carryforward. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X has a $500,000 business credit carryforward from a C year and Asset #1 with a fair market value of $400,000, a basis for regular tax purposes of $95,000, and a basis for alternative minimum tax purposes of $150,000. In 1996, X has net recognized built-in gain of $305,000 from selling Asset #1 for $400,000. Thus, X's tentative tax under paragraph (a)(3) of § 1.1374–1 and regular tax liability under paragraph (b) of this section is $106,750 ($400,000 − $95,000 = $305,000 × .35= $106,750, assuming a 35 percent tax rate). Also, X's tentative minimum tax determined under paragraph (b) of this section is $47,000 [$400,000 − $150,000 = $250,000 − $15,000 ($40,000 corporate exemption amount −$25,000 phase-out = $15,000) = $235,000 × .20 = $47,000, assuming a 20 percent tax rate]. Thus, the business credit limitation under section 38(c) is $59,750 [$106,750 − $47,000 (the greater of $47,000 or $20,438 (.25 × $81,750 ($106,750 − $25,000 = $81,750))) = $59,750]. As a result, X's section 1374 tax is $47,000 ($106,750 − $59,750= $47,000) for 1996 and X has $440,250 ($500,000 − $59,750 = $440,250) of business credit carryforwards for succeeding taxable years.

Example 2. Minimum tax credit. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Asset#1 has a fair market value of $5,000,000, a basis for regular tax purposes of $4,000,000, and a basis for alternative minimum tax purposes of $4,750,000. Y also has a minimum tax credit of $310,000 from 1995. Y has no other assets, no net operating or capital loss carryforwards, and no business credit carryforwards. In 1996, Y's only transaction is the sale of Asset #1 for $5,000,000. Therefore, Y has net recognized built-in gain in 1996 of $1,000,000 ($5,000,000 − $4,000,000 = $1,000,000) and a tentative tax under paragraph (a)(3) of § 1.1374–1 of $350,000 ($1,000,000 × .35 = $350,000, assuming a 35 percent tax rate). Also, Y's tentative minimum tax determined under paragraph (b) of this section is $47,000 [$5,000,000 − $4,750,000 = $250,000 − $15,000 ($40,000 corporate exemption amount −$25,000 phase-out = $15,000) = $235,000 × .20 = $47,000, assuming a 20 percent tax rate]. Thus, Y may use its minimum tax credit in the amount of $303,000 ($350,000 − $47,000 = $303,000) to offset its section 1374 tentative tax. As a result, Y's section 1374 tax is $47,000 ($350,000 − $303,000 = $47,000) in 1996 and Y has a minimum tax credit attributable to years for which Y was a C corporation of $7,000 ($310,000 − $303,000 = $7,000).

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–7 Inventory.

(a) *Valuation.* The fair market value of the inventory of an S corporation on the first day of the recognition period equals the amount that a willing buyer would pay a willing seller for the inventory in a purchase of all the S corporation's assets by a buyer that expects to continue to operate the S corporation's business. For purposes of the preceding sentence, the buyer and seller are presumed not to be under any compulsion to buy or sell and to have reasonable knowledge of all relevant facts.

(b) *Identity of dispositions.* The inventory method used by an S corporation for tax purposes must be used to identify whether the inventory it disposes of during the recognition period is inventory it held on the first day of that period. Thus, a corporation using the LIFO method does not dispose of inventory it held on the first day of the recognition period unless the carrying value of its inventory for a taxable year during that period is less than the carrying value of its inventory on the first day of the recognition period (determined using the LIFO method as described in section 472). However, if a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under section 1374, it must use its former method to identify its dispositions of inventory.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374–8 Section 1374(d)(8) transactions.

(a) *In general.* If any S corporation acquires any asset in a transaction in which the S corporation's basis in the asset is determined (in whole or in part) by reference to a C corporation's basis in the assets (or any other property) (a section 1374(d)(8) transaction), section 1374 applies to the net recognized built-in gain attributable to the assets acquired in any section 1374(d)(8) transaction.

(b) *Effective date of section 1374(d)(8).* Section 1374(d)(8) applies to any section 1374(d)(8) transaction, as defined in paragraph (a)(1) of this section, that occurs on or after December 27, 1994, without regard to the date of the corporation's election to be an S corporation under section 1362.

(c) *Separate determination of tax.* For purposes of the tax imposed under section 1374(d)(8), a separate determination of tax is made with respect to the assets the S corporation acquires in one section 1374(d)(8) transaction from the assets the S corporation acquires in another section 1374(d)(8) transaction and from the assets the corporation held when it became an S corporation. Thus, an S corporation's section 1374 attributes when it became an S corporation may only be used to reduce the section 1374 tax imposed on dispositions of assets the S corporation held at that time. Similarly, an S corporation's section 1374 attributes acquired in a section 1374(d)(8) transaction may only be used to reduce a section 1374 tax imposed on dispositions of assets the S corporation acquired in the same transaction. If an S corporation makes QSub elections under section 1361(b)(3) for a tiered group of subsidiaries effective on the same day, see §1.1361–4(b)(2).

(d) *Taxable income limitation*. For purposes of paragraph (a) of this section, an S corporation's taxable income limitation under §1.1374–2(a)(2) for any taxable year is allocated between or among each of the S corporation's separate determinations of net recognized built-in gain for that year (determined without regard to the taxable income limitation) based on the ratio of each of those determinations to the sum of all of those determinations.

(e) *Examples*. The rules of this section are illustrated by the following examples.

Example 1. Separate determination of tax. (i) X is a C corporation that elected to become an S corporation effective January 1, 1986 (before section 1374 was amended in the Tax Reform Act of 1986). X has a net operating loss carryforward of $20,000 arising in 1985 when X was a C corporation. On January 1, 1996, Y (an unrelated C corporation) merges into X in a transaction to which section 368(a)(1)(A) applies. Y has no loss carryforwards, credits, or credit carryforwards. The assets X acquired from Y are subject to tax under section 1374 and have a net unrealized built-in gain of $150,000.

(ii) In 1996, X has a pre-limitation amount of $50,000 on dispositions of assets acquired from Y and a taxable income limitation of $100,000 (because only one group of assets is subject to section 1374, there is no allocation of the taxable income limitation). As a result, X has a net recognized built-in gain on those assets of $50,000. X's $20,000 net operating loss carryforward may not be used as a deduction against its $50,000 net recognized built-in gain on the assets X acquired from Y. Therefore, X has a section 1374 tax of $17,500 ($50,000 × .35 = $17,500, assuming a 35 percent tax rate) for its 1996 taxable year.

Example 2. Allocation of taxable income limitation. (i) Y is a C corporation that elects to become an S corporation effective January 1, 1996. The assets Y holds when it becomes an S corporation have a net unrealized built-in gain of $5,000. Y has no loss carryforwards, credits, or credit carryforwards. On January 1, 1997, Z (an unrelated C corporation) merges into Y in a transaction to which section 368(a)(1)(A) applies. Z has no loss carryforwards, credits, or credit carryforwards. The assets Y acquired from Z are subject to tax under section 1374 and have a net unrealized built-in gain of $80,000.

(ii) In 1997, Y has a pre-limitation amount on the assets it held when it became an S corporation of $15,000, a pre-limitation amount on the assets Y acquired from Z of $15,000, and a taxable income limitation of $10,000. However, because the assets Y held on becoming an S corporation have a net unrealized built-in gain of $5,000, its net recognized built-in gain on those assets is limited to $5,000 before taking into account the taxable income limitation. Y's taxable income limitation of $10,000 is allocated between the assets Y held on becoming an S corporation and the assets Y acquired from Z for purposes of determining the net recognized built-in gain from each pool of assets. Thus, Y's net recognized built-in gain on the assets Y held on becoming an S corporation is $2,500 [$10,000 × ($5,000/$20,000) = $2,500]. Y's net recognized built-in gain on the assets Y acquired from Z is $7,500 [$10,000 × ($15,000/$20,000) = $7,500]. Therefore, Y has a section 1374 tax of $3,500 [($2,500 + $7,500) × .35 = $3,500, assuming a 35 percent tax rate] for its 1997 taxable year.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994, as amended by T.D. 8869, 65 FR 3856, Jan. 25, 2000; T.D. 9170, 69 FR 76614, Dec. 22, 2004; T.D. 9236, 70 FR 75731, Dec. 21, 2005]

§ 1.1374–9 Anti-stuffing rule.

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under section 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the section 1374 tax.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994]

§ 1.1374–10 Effective date and additional rules.

(a) *In general.* Sections 1.1374–1 through 1.1374–9, other than § 1.1374–3(b) and (c) *Examples 2* through *4*, apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. Section 1.1374–3(b) and (c) *Examples 2* through *4* apply to section 1374(d)(8) transactions that occur in taxable years beginning after February 23, 2005. In addition, an S corporation may apply § 1.1374–3(b) and (c) *Examples 2* through *4* to section 1374(d)(8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended returns that are consistent with these provisions for taxable years of the S corporation during the recognition period of the pool of assets the net unrealized built-in gain of which would be adjusted pursuant to those provisions that are not closed as of the first date after February 23, 2005, that the S corporation files an original or amended return. For purposes of this section, affected shareholders means all shareholders who received distributive shares of S corporation items in such taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to apply these provisions even if all affected shareholders cannot file consistent returns. In addition, for this purpose, a predecessor of an S corporation is a corporation that transfers its assets to the S corporation in a transaction to which section 381 applies. A successor of an S corporation is a corporation to which the S corporation transfers its assets in a transaction to which section 381 applies.

(b) *Additional rules.* This paragraph (b) provides rules applicable to certain S corporations, assets, or transactions to which §§ 1.1374–1 through 1.1374–9 do not apply.

(1) *Certain transfers to partnerships.* If a corporation transfers an asset to a partnership in a transaction to which section 721(a) applies and the transfer is made in contemplation of an S election or during the recognition period, section 1374 applies on a disposition of the asset by the partnership as if the S corporation had disposed of the asset itself. This paragraph (b)(1) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(2) *Certain inventory dispositions.* For purposes of section 1374(d)(2)(A), the inventory method used by the taxpayer for tax purposes (FIFO, LIFO, etc.) must be used to identify whether goods disposed of following conversion to S corporation status were held by the corporation at the time of conversion. Thus, for example, a corporation using the LIFO inventory method will not be subject to the built-in gain tax with respect to sales of inventory except to the extent that a LIFO layer existing prior to the beginning of the first taxable year as an S corporation is invaded after the beginning of that year. This paragraph (b)(2) applies as of the effective date of section 1374, unless the recognition period with respect to the inventory is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(3) *Certain contributions of built-in loss assets.* If a built-in loss asset (that is, an asset with an adjusted tax basis in excess of its fair market value) is contributed to a corporation within 2 years before the earlier of the beginning of its first taxable year as an S corporation, or the filing of its S election, the loss inherent in the asset will not reduce net unrealized built-in gain, as defined in section 1374(d)(1), unless the taxpayer demonstrates a clear and substantial relationship between the contributed property and the conduct of the corporation's current or future business enterprises. This paragraph (b)(3) applies as of the effective date of section 1374, unless the recognition period with respect to the contributed

asset is pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994.

(4) *Certain installment sales*—(i) *In general.* If a taxpayer sells an asset either prior to or during the recognition period and recognizes income either during or after the recognition period from the sale under the installment method, the income will, when recognized, be taxed under section 1374 to the extent it would have been so taxed in prior taxable years if the selling corporation had made the election under section 453(d) not to report the income under the installment method. For purposes of determining the extent to which the income would have been subject to tax if the section 453(d) election had not been made, the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) will be taken into account. This paragraph (b)(4) applies for installment sales occurring on or after March 26, 1990, and before December 27, 1994.

(ii) *Examples.* The rules of this paragraph (b)(4) are illustrated by the following examples.

Example 1. In year 1 of the recognition period under section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 11. Because the corporation does not make an election under section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 11. If the corporation had made an election under section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) would have resulted in $40,000 of the gain being subject to tax during the recognition period under section 1374. Therefore, $40,000 of the gain recognized in year 11 is subject to tax under section 1374.

Example 2. In year 1 of the recognition period under section 1374, a corporation realizes a gain of $100,000 on the sale of an asset with built-in gain. The corporation is to receive full payment for the asset in year 6. Because the corporation does not make an election under section 453(d), all $100,000 of the gain from the sale is reported under the installment method in year 6. If the corporation had made an election under section 453(d) with respect to the sale, the gain would have been recognized in year 1 and, taking into account the corporation's income and gains from other sources, application of the taxable income limitation of section 1374(d)(2)(A)(ii) and the built-in gain carryover rule of section 1374(d)(2)(B) would have resulted in all of the gain being subjected to tax under section 1374 in years 1 through 5. Therefore, notwithstanding that the taxable income limitation of section 1374(d)(2)(A)(ii) might otherwise limit the taxation of the gain recognized in year 6, the entire $100,000 of gain will be subject to tax under section 1374 when it is recognized in year 6.

(c) *Termination and re-election of S corporation status*—(1) *In general.* For purposes of section 633(d)(8) of the Tax Reform Act of 1986, as amended, any reference to an election to be an S corporation under section 1362 shall be treated as a reference to the corporation's most recent election to be an S corporation under section 1362. This paragraph (c) applies for taxable years beginning after December 22, 2004, without regard to the date of the corporation's most recent election to be an S corporation under section 1362.

(2) *Example.* The following example illustrates the rules of this paragraph (c):

Example. (i) Effective January 1, 1988, X, a C corporation that is a qualified corporation under section 633(d) of the Tax Reform Act of 1986, as amended, elects to be an S corporation under section 1362. Effective January 1, 1990, X revokes its S status and becomes a C corporation. On January 1, 2004, X again elects to be an S corporation under section 1362. X disposes of assets in 2006, 2007, and 2008, recognizing gain.

(ii) X is not eligible for treatment under the transition rule of section 633(d)(8) of the Tax Reform Act of 1986, as amended, with respect to these assets. Accordingly, X is subject to section 1374, as amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988, and the 10-year recognition period begins on January 1, 2004.

(iii) To the extent the gain that X recognizes on the asset sales in 2006, 2007, and 2008 reflects built-in gain inherent in such assets in X's hands on January 1, 2004, such gain is subject to tax under section 1374 as amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

[T.D. 8579, 59 FR 66470, Dec. 27, 1994, as amended by T.D. 9170, 69 FR 76614, Dec. 22, 2004; T.D. 9180, 70 FR 8728, Feb. 23, 2005; T.D. 9236, 70 FR 75731, Dec. 21, 2005]

§ 1.1375–1 Tax imposed when passive investment income of corporation having subchapter C earnings and profits exceed 25 percent of gross receipts.

(a) *General rule.* For taxable years beginning after 1981, section 1375(a) imposes a tax on the income of certain S corporations that have passive investment income. In the case of a taxable year beginning during 1982, an electing small business corporation may elect to have the rules under this section not apply. See the regulations under section 1362 for rules on the election. For purposes of this section, the term *S corporation* shall include an electing small business corporation under prior law. This tax shall apply to an S corporation for a taxable year if the S corporation has—

(1) Subchapter C earnings and profits at the close of such taxable year, and

(2) Gross receipts more than 25 percent of which are passive investment income

If the S corporation has no subchapter C earnings and profits at the close of the taxable year (because, for example, such earnings and profits were distributed in accordance with section 1368), the tax shall not be imposed even though the S corporation has passive investment income for the taxable year. If the tax is imposed, the tax shall be computed by multiplying the excess net passive income (as defined in paragraph (b) of this section) by the highest rate of tax specified in section 11(b).

(b) *Definitions*—(1) *Excess net passive income*—(i) *In general.* The term *excess net passive income* is defined in section 1375(b)(1), and can be expressed by the following formula:

$$\mathrm{ENPI} = \mathrm{NPI} \times \frac{\mathrm{PII} - (.25 \times \mathrm{GR})}{\mathrm{PII}}$$

Where:

ENPI = excess net passive income
NPI = net passive income
PII = passive investment income
GR = total gross receipts

(ii) *Limitation.* The amount of the excess net passive income for any taxable year shall not exceed the corporation's taxable income for the taxable year (determined in accordance with section 1374(d) and § 1.1374–1(d)).

(2) *Net passive income.* The term *net passive income* means—

(i) Passive investment income, reduced by

(ii) The deductions allowable under chapter 1 of the Internal Revenue Code of 1954 which are directly connected (within the meaning of paragraph (b)(3) of this section) with the production of such income (other than deductions allowable under section 172 and part VIII of subchapter B).

(3) *Directly connected*—(i) *In general.* For purposes of paragraph (b)(2)(ii) of this section to be directly connected with the production of income, an item of deduction must have proximate and primary relationship to the income. Expenses, depreciation, and similar items attributable solely to such income qualify for deduction.

(ii) *Allocation of deduction.* If an item of deduction is attributable (within the meaning of paragraph (b)(3)(i) of this section) inpart to passive investment income and in part to income other than passive investment income, the deduction shall be allocated between the two types of items on a reasonable basis. The portion of any deduction so allocated to passive investment income shall be treated as proximately and primarily related to such income.

(4) *Other definitions.* The terms *subchapter C earnings and profits*, *passive investment income*, and *gross receipts* shall have the same meaning given these terms in section 1362(d)(3) and the regulations thereunder.

(c) *Special rules*—(1) *Disallowance of credits.* No credit is allowed under part IV of subchapter A of chapter 1 of the Code (other than section 34) against the tax imposed by section 1375(a) and this section.

(2) *Coordination with section 1374.* If any gain—

(i) Is taken into account in determining passive income for purposes of this section, and

(ii) Is taken into account under section 1374,

the amount of such gain taken into account under section 1374(b) and § 1.1374–1(b) (1) and (2) in determining the amount of tax shall be reduced by the portion of the excess net passive income for the taxable year which is attributable (on a pro rata basis) to such gain. For purposes of the preceding sentence, the portion of excess net passive income for the taxable year which is attributable to such capital gain is equal to the amount determined by multiplying the excess net passive income by the following fraction:

$$\frac{NCG - E}{NPI}$$

Where:

NCG = net capital gain

NPI = net passive income.

E = Expense attributable to net capital gain.

(d) *Waiver of tax in certain cases*—(1) *In general.* If an S corporation establishes to the satisfaction of the Commissioner that—

(i) It determined in good faith that it had no subchapter C earnings and profits at the close of the taxable year, and

(ii) During a reasonable period of time after it was determined that it did have subchapter C earnings and profits at the close of such taxable year such earnings and profits were distributed,

the Commissioner may waive the tax imposed by section 1375 for such taxable year. The S corporation has the burden of establishing that under the relevant facts and circumsances the Commissioner should waive the tax.

For example, if an S corporation establishes that in good faith and using due diligence it determined that it had no subchapter C earnings and profits at the close of a taxable year, but it was later determined on audit that it did have subchapter C earnings and profits at the close of such taxable year, and if the corporation establishes that it distributed such earnings and profits within a reasonable time after the audit, it may be appropriate for the Commissioner to waive the tax on passive income for such taxable year.

(2) *Corporation's request for a waiver.* A request for waiver of the tax imposed by section 1375 shall be made in writing to the district director and shall contain all relevant facts to establish that the requirements of paragraph (d)(1) of this section are met. Such request shall contain a description of how and on what date the S corporation in good faith and using due diligence determined that it had no subchapter C earnings and profits at the close of the taxable year, a description of how and on what date it was determined that the S corporation had subchapter C earnings and profits at the close of the year and a description (including dates) of any steps taken to distribute such earnings and profits. If the earnings and profits have not yet been distributed, the request shall contain a timetable for distribution and an explanation of why such timetable is reasonable. On the date the waiver is to become effective, all subchapter C earnings and profits must have been distributed.

(e) *Reduction in pass-thru for tax imposed on excess net passive income.* See section 1366(f)(3) for a special rule reducing each item of the corporation's passive investment income for purposes of section 1366(a) if a tax is imposed on the corporation under section 1375.

(f) *Examples.* The following examples illustrate the principles of this section:

Example 1. Assume Corporation M, an S corporation, has for its taxable year total gross receipts of $200,000, passive investment income of $100,000, $60,000 of which is interest income, and expenses directly connected with the production of such interest income in the amount of $10,000. Assume also that at the end of the taxable year Corporation M has subchapter C earnings and profits. Since more than 25 percent of the Corporation M's total gross receipts are passive investment income, and since Corporation M has subchapter C earnings and profits at the end of the taxable year, Corporation M will be subject to the tax imposed by section 1375. The amount of excess net passive investment income is $45,000 ($90,000 × (50,000 / 100,000)). Assume that the other $40,000 of passive investment income is attributable to net capital gain and that there are no expenses directly connected with such gain. Under these facts, $20,000 of the excess net passive income is attributable to the net capital gain ($45,000 × ($40,000 / $90,000)). Accordingly, the amount of gain taken into account under section 1374(b)(1) and the taxable income of Corporation M under section 1374(b)(2) shall be reduced by $20,000.

Example 2. Assume an S corporation with subchapter C earnings and profits has tax-exempt income of $400, its only passive income, gross receipts of $1,000 and taxable income of $250 and there are no expenses associated with the tax-exempt income. The corporation's excess net income for the taxable year would total $150 (400 × ((400 − 250 / 400)). This amount is subject to the tax imposed by section 1375, notwithstanding that such amount is otherwise tax-exempt income.

[T.D. 8104, 51 FR 34203, Sept. 26, 1986; 52 FR 9162, Mar. 23, 1987. Redesignated and amended by T.D. 8419, 57 FR 22653, May 29, 1992]

§ 1.1377–0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1377–1 through 1.1377–3:

[T.D. 8696, 61 FR 67455, Dec. 23, 1996, as amended by T.D. 8994, 67 FR 34401, May 14, 2002]

§ 1.1377–1 Pro rata share.

(a) *Computation of pro rata shares*—(1) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code and this section, each shareholder's pro rata share of any S corporation item described in section 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day. See paragraph (b) of this section for rules pertaining to the computation of each shareholder's pro rata share when an election is made under section 1377(a)(2) to treat the taxable year of an S corporation as if it consisted of two taxable years in the case of a termination of a shareholder's entire interest in the corporation. See § 1.460–4(k)(3)(iv)(D) for rules relating to the computation of the shareholders' pro rata share of S corporation's income or loss from a contract accounted for under a long-term contract method of accounting.

(2) *Special rules*—(i) *Days on which stock has not been issued.* Solely for purposes of determining a shareholder's pro rata share of an item for a taxable year under section 1377(a) and this section, the beneficial owners of the corporation are treated as the shareholders of the corporation for any day on which the corporation has not issued any stock.

(ii) *Determining shareholder for day of stock disposition.* A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

(iii) Shareholder trust conversions. If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

(b) *Election to terminate year*—(1) *In general.* If a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year and the corporation and all affected shareholders agree, the S corporation may elect under section 1377(a)(2) and this paragraph (b) (terminating election) to apply paragraph (a) of this section to the affected shareholders as if the corporation's taxable year consisted of two separate taxable years, the first of which ends at the close of the day on which the shareholder's entire interest in the S corporation is terminated. If the event resulting in the termination of the shareholder's entire interest also constitutes a qualifying disposition as described in §1.1368–1(g)(2)(i), the election under §1.1368–1(g)(2) cannot be made. An S corporation may not make a terminating election if the cessation of a shareholder's interest occurs in a transaction that results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation. (See section 1362(e)(3) for an election to have items assigned to each short taxable year under normal tax accounting rules in the case of a termination of a corporation's election to be an S corporation.) A terminating election is irrevocable and is effective only for the terminating event for which it is made.

(2) *Affected shareholders.* For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, the term *affected shareholders* means the shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year. If such shareholder has transferred shares to the corporation, the term *affected shareholders* includes all persons who are shareholders during the taxable year.

(3) *Effect of the terminating election*—(i) *In general.* An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for all affected shareholders for purposes of allocating items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account, earnings and profits, and basis; and determining the tax effect of a distribution. An S corporation that makes a terminating election must assign items of income (including tax-exempt income), loss, deduction, and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

(ii) *Due date of S corporation return.* A terminating election does not affect the due date of the S corporation's return required to be filed under section 6037(a) for a taxable year (determined without regard to a terminating election).

(iii) *Taxable year of inclusion by shareholder.* A terminating election does not affect the taxable year in which an affected shareholder must take into account the affected shareholder's pro rata share of the S corporation's items of income, loss, deduction, and credit.

(iv) *S corporation that is a partner in a partnership.* A terminating election by an S corporation that is a partner in a partnership is treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (relating to closing the partnership taxable year), if the taxable year of the partnership ends after the shareholder's interest is terminated and within the taxable year of the S corporation (determined without regard to any terminating election) for which the terminating election is made.

(4) *Determination of whether an S shareholder's entire interest has terminated.* For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, a shareholder's entire interest in an S corporation is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the

shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of any stock (including an interest treated as stock under §1.1361–1(l)) that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.

(5) *Time and manner of making a terminating election*—(i) *In general.* An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return required to be filed under section 6037(a) (that is, a Form 1120S) for the taxable year during which a shareholder's entire interest is terminated. A single election statement may be filed by the S corporation for all terminating elections for the taxable year. The election statement must include—

(A) A declaration by the S corporation that it is electing under section 1377(a)(2) and this paragraph (b) to treat the taxable year as if it consisted of two separate taxable years;

(B) Information setting forth when and how the shareholder's entire interest was terminated (for example, a sale or gift);

(C) The signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury, except that for taxable years beginning after December 31, 2002, the election statement described in §1.1377–1(b)(5)(i) of this section shall be verified, and the requirement of this paragraph (b)(5)(i)(C) is satisfied, by the signature on the Form 1120S filed by the S corporation.

(D) A statement by the corporation that the corporation and each affected shareholder consent to the S corporation making the terminating election.

(ii) *Affected shareholders required to consent.* For purposes of paragraph (b)(5)(i)(D) of this section, a shareholder of the S corporation for the taxable year is a shareholder as described in section 1362(a)(2). For example, the person who under §1.1362–6(b)(2) must consent to a corporation's S election in certain special cases is the person who must consent to the terminating election. In addition, an executor or administrator of the estate of a deceased affected shareholder may consent to the terminating election on behalf of the deceased affected shareholder.

(iii) *More than one terminating election.* A shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to a terminating election made with respect to a subsequent termination within the same taxable year unless the shareholder is an affected shareholder with respect to the subsequent termination.

(c) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Shareholder's pro rata share in the case of a partial disposition of stock. (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells 50 shares of X stock to C. Thus, in 1997, A owned 50 percent of the outstanding shares of X on each day of X's 1997 taxable year, B owned 50 percent on each day from January 6, 1997, to July 24, 1997 (200 days), and 25 percent from July 25, 1997, to December 31, 1997 (160 days), and C owned 25 percent from July 25, 1997, to December 31, 1997 (160 days).

(ii) Because B's entire interest in X is not terminated when B sells 50 shares to C on July 24, 1997, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section for B's sale of 50 shares to C. Although B's sale of 50 shares to C is a qualifying disposition under §1.1368–1(g)(2)(i), X does not make an election to terminate its taxable year under §1.1368–1(g)(2). During its 1997 taxable year, X has nonseparately computed income of $720,000.

(iii) For each day in X's 1997 taxable year, A's daily pro rata share of X's nonseparately computed income is $1,000 ($720,000/360 days × 50%). Thus, A's pro rata share of X's nonseparately computed income for 1997 is $360,000 ($1,000 × 360 days). B's daily pro rata share of X's nonseparately computed income is $1,000 ($720,000/360 × 50%) for the first 200 days of X's 1997 taxable year, and $500 ($720,000/360 × 25%) for the following 160 days in 1997. Thus, B's pro rata share of X's nonseparately computed income for 1997 is $280,000 (($1,000 × 200 days) + ($500 × 160 days)). C's daily pro rata share of X's nonseparately computed income is $500 ($720,000/360 × 25%) for 160 days in 1997. Thus, C's pro rata share of X's nonseparately computed income for 1997 is $80,000 ($500 × 160 days).

Example 2. Shareholder's pro rata share when an S corporation makes a terminating election under section 1377(a)(2). (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells B's entire 100 shares of X stock to C. With the consent of B and C, X makes an election under section 1377(a)(2) and paragraph (b) of this section for the termination of B's entire interest arising from B's sale of 100 shares to C. As a result of the election, the pro rata shares of B and C are determined as if X's taxable year consisted of two separate taxable years, the first of which ends on July 24, 1997, the date B's entire interest in X terminates. Because A is not an affected shareholder as defined by section 1377(a)(2)(B) and paragraph (b)(2) of this section, the treatment as separate taxable years does not apply to A.

(ii) During its 1997 taxable year, X has nonseparately computed income of $720,000. Under X's normal method of accounting, $200,000 of the $720,000 of nonseparately computed income is allocable to the period of January 6, 1997, through July 24, 1997 (the first deemed taxable year), and the remaining $520,000 is allocable to the period of July 25, 1997, through December 31, 1997 (the second deemed taxable year).

(iii) B's pro rata share of the $200,000 of nonseparately computed income for the first deemed taxable year is determined by assigning the $200,000 of nonseparately computed income to each day of the first deemed taxable year ($200,000/200 days = $1,000 per day). Because B held 50% of X's authorized and issued shares on each day of the first deemed taxable year, B's daily pro rata share for each day of the first deemed taxable year is $500 ($1,000 per day × 50%). Thus, B's pro rata share of the $200,000 of nonseparately computed income for the first deemed taxable year is $100,000 ($500 per day × 200 days). B must report this amount for B's taxable year with or within which X's full taxable year ends (December 31, 1997).

(iv) C's pro rata share of the $520,000 of nonseparately computed income for the second deemed taxable year is determined by assigning the $520,000 of nonseparately computed income to each day of the second deemed taxable year ($520,000/160 days = $3,250 per day). Because C held 50% of X's authorized and issued shares on each day of the second deemed taxable year, C's daily pro rata shares for each day of the second deemed taxable year is $1,625 ($3,250 per day × 50%). Therefore, C's pro rata share of the $520,000 of nonseparately computed income is $260,000 ($1,625 per day × 160 days). C must report this amount for C's taxable year with or within which X's full taxable year ends (December 31, 1997).

Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT). (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to §1.1361–1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's pro rata share of S corporation's nonseparately computed income is $100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the pro rata share of S corporation income allocated to the QSST is $49,727 ($100,000 × 182 days/366 days), and the pro rata share of S corporation income allocated to the ESBT is $50,273 ($100,000 × 184 days/366 days).

[T.D. 8696, 61 FR 67456, Dec. 23, 1996, as amended by T.D. 8994, 67 FR 34401, May 14, 2002; T.D. 9100, 68 FR 70706, Dec. 19, 2003; T.D. 9137, 69 FR 42559, July 16, 2004; T.D. 9300, 71 FR 71043, Dec. 8, 2006]

§ 1.1377–2 Post-termination transition period.

(a) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code (Code) and this section, the term *post-termination transition period* means—

(1) The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

(i) The day which is 1 year after such last day; or

(ii) The due date for filing the return for the last taxable year as an S corporation (including extensions);

(2) The 120-day period beginning on the date of any determination pursuant

to an audit of the taxpayer which follows the termination of the corporation's election and which adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in section 1368(e)(2)); and

(3) The 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

(b) *Special rules for post-termination transition period.* Pursuant to section 1377(b)(1) and paragraph (a)(1) of this section, a post-termination transition period arises the day after the last day that an S corporation was in existence if a C corporation acquires the assets of the S corporation in a transaction to which section 381(a)(2) applies. However, if an S corporation acquires the assets of another S corporation in a transaction to which section 381(a)(2) applies, a post-termination transition period does not arise. (See §1.1368–2(d)(2) for the treatment of the acquisition of the assets of an S corporation by another S corporation in a transaction to which section 381(a)(2) applies.) The special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period is available only to those shareholders who were shareholders in the S corporation at the time of the termination.

(c) *Determination defined.* For purposes of section 1377(b)(1) and paragraph (a) of this section, the term *determination* means—

(1) A determination as defined in section 1313(a);

(2) A written agreement between the corporation and the Commissioner (including a statement acknowledging that the corporation's election to be an S corporation terminated under section 1362(d)) that the corporation failed to qualify as an S corporation;

(3) For a corporation subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A of the Code, the expiration of the period specified in section 6226 for filing a petition for readjustment of a final S corporation administrative adjustment finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period; and

(4) For a corporation not subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A of the Code, the expiration of the period for filing a petition under section 6213 for the shareholder's taxable year for which the Commissioner has made a finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period.

(d) *Date a determination becomes effective*—(1) *Determination under section 1313(a).* A determination under paragraph (c)(1) of this section becomes effective on the date prescribed in section 1313 and the regulations thereunder.

(2) *Written agreement.* A determination under paragraph (c)(2) of this section becomes effective when it is signed by the district director having jurisdiction over the corporation (or by another Service official to whom authority to sign the agreement is delegated) and by an officer of the corporation authorized to sign on its behalf. Neither the request for a written agreement nor the terms of the written agreement suspend the running of any statute of limitations.

(3) *Implied agreement.* A determination under paragraph (c) (3) or (4) of this section becomes effective on the day after the date of expiration of the period specified under section 6226 or 6213, respectively.

[T.D. 8696, 61 FR 67457, Dec. 23, 1996]

§ 1.1377–3 Effective dates.

Section 1.1377–1 and 1.1377–2 apply to taxable years of an S corporation beginning after December 31, 1996, except that §1.1377–1(a)(2)(iii), and (c) *Example 3* are applicable for taxable years beginning on and after May 14, 2002.

[T.D. 8994, 67 FR 34401, May 14, 2002]

§ 1.1378–1 Taxable year of S corporation.

(a) *In general.* The taxable year of an S corporation must be a permitted year. A permitted year is the required taxable year (*i.e.*, a taxable year ending on December 31), a taxable year elected under section 444, a 52–53-week taxable year ending with reference to the required taxable year or a taxable year elected under section 444, or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner under section 442.

(b) *Adoption of taxable year.* An electing S corporation may adopt, in accordance with § 1.441–1(c), its required taxable year, a taxable year elected under section 444, or a 52–53-week taxable year ending with reference to its required taxable year or a taxable year elected under section 444 without the approval of the Commissioner. See § 1.441–1. An electing S corporation that wants to adopt any other taxable year, must establish a business purpose and obtain the approval of the Commissioner under section 442.

(c) *Change in taxable year*—(1) *Approval required.* An S corporation or electing S corporation that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, an S corporation or electing S corporation may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(2) *Short period tax return.* An S corporation or electing S corporation that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the corporation's taxable income.

(d) *Retention of taxable year.* In certain cases, an S corporation or electing S corporation will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that elects to be an S corporation and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(e) *Procedures for obtaining approval or making a section 444 election*—(1) *In general.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

(2) *Special rules for electing S corporations.* An electing S corporation that wants to adopt, change to, or retain a taxable year other than its required taxable year must request approval of the Commissioner on Form 2553, ''Election by a Small Business Corporation,'' when the election to be an S corporation is filed pursuant to section 1362(b) and § 1.1362–6. See § 1.1362–6(a)(2)(i) for the manner of making an election to be an S corporation. If such corporation receives permission to adopt, change to, or retain a taxable year other than its required taxable year, the election to be an S corporation will be effective. Denial of the request renders the election ineffective unless the corporation agrees that, in the event the request to adopt, change to, or retain a taxable year other than its required taxable year is denied, it will adopt, change to, or retain its required taxable year or, if applicable, make an election under section 444.

(f) *Effective date.* The rules of this section are applicable for taxable years ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35024, May 17, 2002]

SECTION 1374 BEFORE THE TAX REFORM ACT OF 1986

§ 1.1374–1A Tax imposed on certain capital gains.

(a) *General rule.* Except as otherwise provided in paragraph (c) of this section, if for a taxable year beginning after 1982 of an S corporation—

(1) The net capital gain of such corporation exceeds $25,000, and

(2) The net capital gain of such corporation exceeds 50 percent of its taxable income (as defined in paragraph (d) of this section) for such year, and

(3) The taxable income of such corporation (as defined in paragraph (d) of this section) for such year exceeds $25,000,

section 1374 imposes a tax (computed under paragraph (b) of this section) on the income of such corporation. The