

Notice of Proposed Rulemaking and Notice of Public Hearing

Pass Through of Items of an S Corporation to its Shareholders

REG-209446-82

AGENCY: Internal Revenue Service
(IRS), Treasury.

ACTION: Notice of proposed rulemak-
ing and notice of public hearing.

SUMMARY: This document contains pro-
posed regulations relating to the pass
through of items of an S corporation to its
shareholders, the adjustments to the basis
of stock of the shareholders, and the treat-
ment of distributions by an S corporation.
Changes to the applicable law were made
by the Subchapter S Revision Act of 1982,
the Tax Reform Act of 1984, the Tax Re-
form Act of 1986, the Technical and Mis-
cellaneous Revenue Act of 1988, and the
Small Business Job Protection Act of 1996.
These proposed regulations provide the
public with guidance needed to comply
with the applicable law and will affect S
corporations and their shareholders. This
document also contains a notice of public
hearing on these proposed regulations.

DATES: Written comments must be re-
ceived by November 16, 1998. Outlines
of topics to be discussed at the public
hearing scheduled for Tuesday, December
15, 1998, at 10 a.m. must be received by
Tuesday, November 24, 1998.

ADDRESSES: Send submissions to:
CC:DOM:CORP:R (REG-209446-82),
room 5226, Internal Revenue Service,
POB 7604, Ben Franklin Station, Wash-
ington, DC 20044. Submissions may be
hand delivered between the hours of 8
a.m. and 5 p.m. to: CC:DOM:CORP:R
(REG-209446-82), Courier's Desk, In-
ternal Revenue Service, 1111 Constitution
Avenue, NW, Washington, DC. Alternat-
ively, taxpayers may submit comments
electronically via the Internet by selecting
the "Tax Regs" option on the IRS Home
Page, or by submitting comments directly
to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regsg/comments.html.

The public hearing will be held in room
2615, Internal Revenue Building, 1111
Constitution Avenue, NW, Washington,
DC.

FOR FURTHER INFORMATION CON-
TACT: Concerning the regulations under
section 1366, Deane M. Burke or Terri A.
Belanger, (202) 622-3070; concerning the
regulations under sections 1367 and 1368,
Brenda Stewart, (202) 622-3120; con-
cerning submissions and the hearing,
Michael Slaughter, (202) 622-7180 (not
toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained
in this notice of proposed rulemaking has
been submitted to the Office of Manage-
ment and Budget for review in accor-
dance with the Paperwork Reduction Act
of 1995 (44 U.S.C. 3507(d)). Comments
on the collection of information should be
sent to the **Office of Management and
Budget**, Attn: Desk Officer for the De-
partment of the Treasury, Office of Infor-
mation and Regulatory Affairs, Washing-
ton, DC 20503, with copies to the
Internal Revenue Service, Attn: IRS Re-
ports Clearance Officer, OP:FS:FP, Wash-
ington, DC 20224. Comments on the col-
lection of information should be received
by October 19, 1998. Comments are
specifically requested concerning:

Whether the proposed collection of in-
formation is necessary for the proper per-
formance of the functions of the Internal
Revenue Service, including whether the
information will have practical utility;

The accuracy of the estimated burden
associated with the proposed collection of
information (see below);

How the quality, utility, and clarity of
the information to be collected may be en-
hanced;

How the burden of complying with the
proposed collection of information may
be minimized, including through the ap-
plication of automated collection tech-
niques or other forms of information tech-
nology; and

Estimates of capital or start-up cost and
costs of operation, maintenance, and pur-
chase of service to provide information.

The collection of information in this
proposed regulation is in §1.1366-1. This

information is required in order for a
shareholder in an S corporation to prop-
erly compute its tax liability. This infor-
mation will be used to determine whether
the amount of tax has been computed cor-
rectly. Responses to this collection of in-
formation are mandatory for shareholders
in S corporations. The likely respondents
are individuals and businesses or other
for-profit institutions.

The reporting burden contained in
§1.1366-1 is reflected in the burden of
Form 1040, U.S. Individual Income Tax
Return, and Form 1120S, U.S. Income
Tax Return for an S Corporation.

Newly designated §1.1367-1(g) does
not impose a new collection of informa-
tion. The election in newly designated
§1.1367-1(g), previously contained in
§1.1367-1(f), was approved by OMB
under OMB Control Number 1545-1139.

An agency may not conduct or sponsor,
and a person is not required to respond to,
a collection of information unless the col-
lection of information displays a valid
control number.

Books or records relating to a collec-
tion of information must be retained as
long as their contents may become mater-
ial in the administration of any internal
revenue law. Generally, tax returns and
tax return information are confidential, as
required by 26 U.S.C. 6103.

Background

This document contains proposed
amendments to the Income Tax Regula-
tions (26 CFR part 1) under sections
1366, 1367, and 1368 of the Internal Re-
venue Code of 1986 (Code). Sections
1366, 1367, and 1368 were added by the
Subchapter S Revision Act of 1982 (1982
Act) (Public Law 97-354, 96 Stat. 1669,
1697). Section 1366 was amended by the
Tax Reform Act of 1984 (Public Law 98-
369, 98 Stat. 844, 985), the Tax Reform
Act of 1986 (Public Law 99-514, 100
Stat. 2085, 2277, 2343), the Technical and
Miscellaneous Revenue Act of 1988
(Public Law 100-647, 102 Stat. 3406),
and the Small Business Job Protection Act
of 1996 (1996 Act) (Public Law 104-188,
110 Stat. 1755).

Sections 1367 and 1368 were amended
by the Technical Corrections Act of 1982
(Public Law 97-448, 96 Stat. 2365,
2399-2400), the Tax Reform Act of 1984
(Public Law 98-369), and the Tax Reform

Act of 1986 (Public Law 99-514). Final regulations conforming the regulations to these amendments were published in the **Federal Register** on January 3, 1994. The proposed amendments would conform the regulations to amendments made to sections 1367 and 1368 by the 1996 Act.

Explanation of Provisions

Determination of Shareholder's Tax Liability

Under section 1363, an S corporation generally computes its taxable income in the same manner as an individual, subject to certain modifications. Thus, for example, an S corporation is not entitled to a dividends received deduction under section 243.

Section 1366(a)(1) and the proposed regulations provide rules under which a shareholder of an S corporation takes into account the shareholder's pro rata share, as defined under section 1377, of the corporation's items of income, loss, deduction, or credit. A shareholder's share of these items is determined for the shareholder's taxable year in which the taxable year of the S corporation ends. If a shareholder dies before the end of the corporation's taxable year, the shareholder's pro rata share of these items is taken into account in the shareholder's final tax return. If a shareholder is an estate or trust, and the estate or trust terminates before the end of the corporation's taxable year, the shareholder's pro rata share of these items is taken into account in the shareholder's final tax return.

In the case of most items that must be separately stated by an S corporation, the provisions by which an S corporation accounts to its shareholders for tax purposes under section 1366 closely parallel the provisions for a partnership accounting to its partners under section 702. The proposed regulations provide rules outlining this general pass-through scheme for S corporations to their shareholders.

Under section 1366(a)(1)(A), an S corporation's items of income, loss, deduction, and credit must be separately stated if their separate treatment on any shareholder's income tax return could affect the shareholder's tax liability. These separately stated items include, but are not limited to, short-term and long-term capital gain or loss, other items that may be

relevant to the shareholder in the computation of the shareholder's tax liability resulting from the sale or exchange of capital assets or assets described in section 1231(b), tax-exempt income, section 170(c) charitable contributions, certain foreign taxes, items used in determining certain credits, certain itemized deductions, items of portfolio income or loss and related expenses under section 469, and the corporation's adjustments in computing alternative minimum tax under sections 56 and 58 and any items of tax preference under section 57. All items of income, loss, and deduction that are not separately stated must be combined to compute the nonseparately computed income or loss of the S corporation under section 1366(a)(1)(B).

Identification of Tax-exempt Income

The proposed regulations define tax-exempt income as income that is permanently excludible from the gross income of an S corporation and its shareholders in all circumstances in which the relevant Code section applies. For example, tax-exempt income includes proceeds of life insurance contracts that are payable by reason of an individual's death and that are excludible from gross income under section 101, and interest on state and local bonds that is excludible from gross income under section 103.

However, income that is excludible from gross income pursuant to a provision of the Code that might have the effect of deferring income to the S corporation or its shareholders is not tax-exempt income. For example, income from improvements by a lessee on a lessor's property that is excludible from gross income under section 109 is not tax-exempt income because, for example, the lessor would recognize the value of the improvements as income when the property is sold by the lessor. Similarly, income from the discharge of indebtedness that is excludible from gross income under section 108 does not constitute tax-exempt income because the attribute reduction provisions of section 108(b) have the effect of deferring the recognition of such income in some circumstances while permanently excluding it, in whole or in part, in other circumstances.

Treasury and the IRS believe that Congress intended that section 108 would

allow taxpayers to avoid the immediate adverse tax consequences that could otherwise result from the inclusion of income from discharge of indebtedness. The deferral of income excluded under section 108(a)(1) by reducing the basis of property or other tax attributes is one method of achieving this purpose. For example, the legislative history of section 108(a)(1)(D) provides that the exclusion from gross income for discharge of qualified real property business indebtedness income simply defers income to the shareholders of an S corporation and does not result in an adjustment to the basis of the stock of the corporation. See H.R. Rep. No. 111, 103d Cong., 1st Sess. 625 (1993); H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 555 (1993).

Other specific rules apply to the discharge of indebtedness of an S corporation. See section 108(d)(7). The legislative history of section 108(d)(7)(A) provides that in order to treat all shareholders in the same manner, the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses that are not allowed by reason of any shareholder's basis limitation) are made at the corporate level. See H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, 1640-41 (1984). Furthermore, the legislative history of section 108 indicates that any cancellation of indebtedness income remaining after the reduction of the S corporation's tax attributes does not result in income or have other tax consequences. See S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980). Thus, the absence of a stock basis increase for income of an S corporation excluded under section 108(a) is consistent with the legislative history of section 108 (and its purpose to avoid the immediate adverse tax consequences that could otherwise result from the inclusion of income from discharge of indebtedness) and the specific rules that apply to the discharge of indebtedness income of S corporations.

Finally, even though a partner is entitled to an increase in the basis of the partner's interest for income from discharge of indebtedness of a partnership that is excluded under section 108(a), a shareholder of an S corporation is not entitled to an increase in stock basis under similar circumstances. This difference is appro-

appropriate because the principal provisions of section 108 are applied at the corporate level in the case of an S corporation but at the partner level in the case of a partnership. See section 108(d)(6). A basis increase in the partner's interest in the partnership is necessary in order to apply these provisions at the partner level because, for example, the income may properly be excluded by some partners and included by others, and in order to offset the basis reduction that will occur under section 752(b) as the result of the deemed distribution arising out of the decrease in the partner's share of partnership liabilities. These considerations are not present in the case of an S corporation.

Accordingly, Treasury and the IRS believe that income excluded by an S corporation pursuant to section 108 is not tax-exempt income for purposes of section 1366 whether or not the application of section 108 in a particular circumstance results in the permanent exclusion, in whole or in part, of income. See also *Nelson v. Commissioner*, 110 T.C. 114 (1998).

Pass Through of Character and Gross Income

Consistent with the adoption of parallel operational rules between sections 702 and 1366, the items of an S corporation are generally characterized in the same manner that partnership items are characterized. The partnership rules provide that the character of a partnership item reported by a partner is generally determined at the entity level under a conduit rule. The proposed regulations provide a similar conduit rule under which the character of a corporate item that is passed through to and reported by a shareholder is generally determined at the corporate level. However, exceptions to the general rule apply for contributions of either non-capital gain property or capital loss property if an S corporation is formed or availed of by any shareholder or shareholders for a principal purpose of selling or exchanging the property to alter the character of the gain or loss. The character of the gain or loss will be the same as it would have been if the property were in the hands of the shareholder or shareholders at the time of the sale or exchange.

Section 1366(c), like section 702(c), provides for the pass through of gross in-

come to a shareholder for federal income tax purposes. Thus, 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. This amount is the amount of gross income of the corporation used to derive the shareholder's pro rata share of S corporation taxable income or loss. See Rev. Rul. 87-121 (1987-2 C.B. 217).

Limitation on Losses and Deductions

In general, section 1366(d)(1) and the proposed regulations provide that the amount of losses and deductions taken into account by a shareholder for any taxable year may not exceed the sum of the shareholder's adjusted bases in the stock of the S corporation and in any indebtedness of the S corporation to the shareholder. Moreover, any loss or deduction for the taxable year not taken into account by a shareholder by reason of the basis limitation rule is treated under section 1366(d)(2) and the proposed regulations as incurred by the corporation with respect to that shareholder in the corporation's first succeeding taxable year, and subsequent taxable years. For purposes of the basis limitation rule in section 1366(d), the basis of stock acquired by gift is the basis of the stock for determining loss under section 1015. The basis rules under section 1015 operate to minimize the loss recognized by a donee upon the sale or exchange of the loss stock acquired by gift. Therefore, the basis limitation rule limits a donee shareholder's pass-through items of loss or deduction to the basis used for determining loss upon the sale or exchange of the stock acquired by gift.

The proposed regulations provide that if a shareholder's aggregate pro rata share of the items of loss and deduction exceeds the sum of the shareholder's adjusted bases in stock and debt, the limitation on losses and deductions must be allocated among the shareholder's pro rata share of each loss or deduction. This allocation is determined by taking the proportion that each loss or deduction bears to the total of all losses and deductions, including those previously disallowed.

Also under the proposed regulations, a shareholder's disallowed losses and de-

ductions are personal to that shareholder and cannot be transferred. Moreover, if a shareholder transfers all of the shareholder's stock in an S corporation, any disallowed loss or deduction is permanently disallowed.

The proposed regulations provide special rules for a shareholder to carry over disallowed losses and deductions to any post-termination transition period. Those special rules generally follow the limitation rules provided in the proposed regulations for years in which the S corporation election is in effect, except that the amount of losses and deductions that may be taken into account is limited to the adjusted basis of the shareholder's stock (rather than stock and debt) in the corporation determined at the close of the post-termination transition period. See section 1366(d)(3)(B).

Finally, the proposed regulations provide rules regarding the carryover of disallowed losses and deductions in the event of certain corporate reorganizations. If a corporation acquires, in a transaction to which section 381(a) applies, the assets of another S corporation for which disallowed losses and deductions would carry over with respect to a shareholder under section 1366(d)(2), except for the reorganization, the losses and deductions will be available to that shareholder. Where the acquiring corporation is an S corporation, the losses and deductions will be treated as incurred by the acquiring S corporation with respect to that shareholder. Where the acquiring corporation is a C corporation, the proposed regulations provide special rules for a shareholder to carry over disallowed losses and deductions to any post-termination transition period under section 1377 if the shareholder is a shareholder of the C corporation after the transaction.

In the case of an S corporation that 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 355 as relates to section 355) applies, any disallowed loss or deduction with respect to a shareholder of the distributing corporation immediately before the transaction is allo-

cated between the distributing corporation and the controlled corporation with respect to the shareholder. This allocation is made in proportion to the fair market value of the shareholder's stock of the distributing corporation and the shareholder's stock of the controlled corporation, determined immediately after the transaction.

Treatment of Family Group

In general, the proposed regulations provide for the reallocation of items of the corporation among family members under certain conditions. Section 1366(e) requires a determination of whether an individual family member who renders services for or provides capital to the S corporation has received reasonable compensation. The proposed regulations provide that in determining a reasonable allowance for services rendered for, or capital furnished to, the S corporation, all the facts and circumstances are considered, including the amount that ordinarily would be paid in order to obtain comparable services or capital from a person who is neither a member of that family nor a shareholder in the corporation.

For purposes of section 1366(e), similar rules apply to services rendered, or capital furnished, to an S corporation by a pass-through entity in which a member of a shareholder's family holds an interest. The proposed regulations provide that if the pass-through entity does not receive reasonable compensation for the services rendered or capital furnished, the Commissioner may prescribe adjustments to the pass-through entity and the corporation as necessary to reflect the value of the services rendered or capital furnished.

Special Rules

Section 1366(f) and the proposed regulations provide special rules limiting the pass through of certain items of an S corporation to its shareholders. Section 1366(f)(1) and the proposed regulations provide that the pass-through rules under section 1366(a) are inapplicable with respect to any credit allowable under section 34 (relating to certain uses of gasoline and special fuels). In addition, section 1366(f)(2) and (3) and the proposed regulations provide for a reduction in the pass through of items for tax im-

posed on an S corporation under section 1374 or section 1375.

Adjustments to Basis of Stock

Section 1367(a) and §1.1367-1 prescribe adjustments required by subchapter S to the basis of a shareholder's stock in an S corporation and the manner in which those adjustments are made. Section 1.1367-1 requires a shareholder in an S corporation to adjust the basis of the shareholder's stock for items of income and loss for any taxable year before adjusting the basis for distributions.

Section 1309 of the 1996 Act amended section 1368 to require that in the case of any distribution made during any taxable year, the adjusted basis of the stock is determined with regard to the adjustments provided in section 1367(a)(1) for the taxable year. Thus, the adjustments for distributions made by the S corporation during the taxable year are taken into account before applying the loss limitation for the year.

The proposed regulations amend §1.1367-1 to provide that for taxable years of the corporation beginning on or after August 18, 1998, adjustments to the basis of a share of stock are made in the following order: (1) increases for income items and the excess of deductions for depletion over the basis of the property subject to depletion; (2) decreases for distributions; (3) decreases for noncapital, nondeductible expenses, and certain oil and gas depletion deductions; and (4) decreases for items of loss or deduction.

Adjustments Required Before Determining Tax Effect of Distribution

Section 1368 provides rules for determining the source of a distribution made by an S corporation with respect to its stock and the tax effect of the distribution on the shareholders. Under §1.1368-1, the determination whether a distribution is made out of the accumulated adjustments account (AAA) or earnings and profits is made only after the AAA has been adjusted to reflect: (1) increases for income items (other than income that is exempt from tax) and the excess of the deductions for depletion over the basis of the property subject to depletion; (2) decreases for noncapital, nondeductible expenses (other than federal taxes attributable to any taxable year in which the

corporation was a C corporation and expenses related to income that is exempt from tax); (3) decreases for certain oil and gas depletion deductions; (4) decreases for items of loss or deduction; and (5) the effect of certain redemptions.

Consistent with the proposed amendments to §1.1367-1, the proposed regulations amend §1.1368-2 to provide that for taxable years of the corporation beginning on or after August 18, 1998, the adjustments to the AAA are made in the same order as the adjustments to the basis of a share of stock under §1.1367-1 of the proposed regulations. For purposes of determining the amount of any distribution made from the AAA, decreases to the AAA to reflect distributions are made without taking into account any net negative adjustments as defined in section 1368(e)(1)(C)(ii).

Section 1311(a) of the 1996 Act generally eliminated the S corporation earnings and profits of a corporation accumulated in those taxable years beginning before January 1, 1983, for which the corporation was an electing small business corporation under the provisions of subchapter S of the Code as then in effect, if the corporation was also an S corporation for its first taxable year beginning after December 31, 1996. Several provisions of the existing final regulations under subchapter S, which were adopted before the 1996 Act amendments, refer separately to S corporation earnings and profits and C corporation earnings and profits. See, e.g., §1.1368-1(f)(2)(iii). Treasury and the IRS specifically request comments on the extent, if any, to which these regulations should be amended in view of the general elimination of S corporation earnings and profits. Treasury and the IRS also request comments on whether section 1311(a) of the 1996 Act applies to qualified casualty insurance electing small business corporations and qualified oil corporations, within the meaning of section 6(c) of the 1982 Act.

Proposed Effective Date

The regulations under section 1366 and the amendments to the regulations under sections 1367 and 1368 are proposed to be effective for taxable years of the corporation beginning on or after August 18, 1998.

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations do not impose a collection of information that is not already required by the underlying statute or the current regulations and reflected in the appropriate forms. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (a signed original and eight (8) copies) to the IRS. All comments will be made available for public inspection and copying.

A public hearing has been scheduled for Tuesday, December 15, 1998, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments (a signed original and eight (8) copies) by November 16, 1998. The outline of topics to be discussed at the hearing must be received by Tuesday, November 24, 1998.

A period of 10 minutes will be allotted for each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the

deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Deane M. Burke, Terri A. Belanger, and Brenda Stewart of the Office of Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAX

Paragraph 1. The authority citation for part 1 continues to read in part:

Authority: 26 U.S.C. 7805 * * * *

§§1.1366-1 and 1.1366-2 [Removed]

Par. 2. Sections 1.1366-1 and 1.1366-2 are removed.

Par. 3. Sections 1.1366-0 through 1.1366-5 are added to read as follows:

§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:

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

- (a) Determination of shareholder's tax liability.
 - (1) In general.
 - (2) Separately stated items of income, loss, deduction, or credit.
 - (3) Nonseparately computed income or loss.
 - (4) Separate activities requirement.
 - (5) Aggregation of deductions or exclusions for purposes of limitations.
- (b) Character of items constituting pro rata share.
 - (1) In general.
 - (2) Exception for contribution of non-capital gain property.
 - (3) Exception for contribution of capital loss property.
- (c) Gross income of a shareholder.
 - (1) In general.

- (2) Gross income for substantial omission of items.
- (d) Shareholders holding stock subject to community property laws.
- (e) Net operating loss deduction of shareholder of S corporation.
- (f) Cross-reference.

§1.1366-2 Limitations on deduction of pass-through items of an S corporation to its shareholders.

- (a) In general.
 - (1) Limitation on losses and deductions.
 - (2) Carryover of disallowance.
 - (3) Basis limitation amount.
 - (i) Stock portion.
 - (ii) Indebtedness portion.
 - (4) Limitation on losses and deductions allocated to each item.
 - (5) Nontransferability of losses and deductions.
 - (6) Basis of stock acquired by gift.
- (b) Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b).
 - (1) In general.
 - (2) Limitation on losses and deductions.
 - (3) Limitation on losses and deductions allocated to each item.
 - (4) Adjustment to the basis of stock.
 - (c) Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions.
 - (1) Liquidations and reorganizations.
 - (2) Corporate separations to which section 368(a)(1)(D) applies.

§1.1366-3 Treatment of family groups.

- (a) In general.
- (b) Examples.

§1.1366-4 Special rules limiting the pass through of certain items of an S corporation to its shareholders.

- (a) Pass through inapplicable to section 34 credit.
- (b) Reduction in pass through for tax imposed on built-in gains.
- (c) Reduction in pass through for tax imposed on excess net passive income.

§1.1366-5 Effective date.

§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 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, an 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 para-

graph (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 (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 non-capital 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 \$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).

§1.1366-2 Limitations on deduction of pass-through 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)(3)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraph (a)(3)(ii) of this section).

(2) *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 is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder to the extent that the shareholder's adjusted basis of stock or indebtedness exceeds zero. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(3)(i) and (ii) of this section.

(3) *Basis limitation amount*—(i) *Stock portion*. A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (2) 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(f) (proposed to be redesignated as §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 (2) 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.

(4) *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)(3)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(3)(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).

(5) *Nontransferability of losses and deductions*. 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.

(6) *Basis of stock acquired by gift*. For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (2) 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.

(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.

(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. The amount of disallowed loss or deduction allocated to the distributing (or controlled) corporation with respect to the shareholder is an amount that bears the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the distributing (or controlled) corporation bears to the total value of the shareholder's stock in the distributing and controlled corporations, in each case as determined immediately after the distribution.

§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 pass-through 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 pass-through 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 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.

§1.1366-4 Special rules limiting the pass through of certain items of an S corporation to its shareholders.

(a) *Pass through 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 pass through 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 recognized built-in gain items giving rise to the tax and attributing the character of each recognized built-in gain item to the allocable portion of the loss.

(c) *Reduction in pass through 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 amount of the item bears to the total passive investment income for that taxable year.

§1.1366-5 Effective date.

Sections 1.1366-1 through 1.1366-4 apply to taxable years of an S corporation beginning on or after August 18, 1998.

Par. 4. Section 1.1367-0 is amended in the table as follows:

1. The entries for §1.1367-1(e) through (g) are revised.
2. The entries for §1.1367-1(h) through (j) are added.

The additions and revisions read as follows:

§1.1367-0 Table of contents.

* * * * *

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

* * * * *

(e) Ordering rules for taxable years beginning before January 1, 1997.

(f) Ordering rules for taxable years beginning on or after August 18, 1998.

(g) Elective ordering rule.

(h) Examples.

(i) [Reserved]

(j) Adjustments for items of income in respect of a decedent.

* * * * *

Par. 5. Section 1.1367-1 is amended as follows:

1. The heading and introductory text of paragraph (e) are revised.

2. Paragraphs (f) and (g) are redesignated as paragraphs (g) and (h), respectively.

3. New paragraph (f) is added.

4. The first and second sentences of newly designated paragraph (g) are revised.

5. Newly designated paragraph (h) is amended as follows:

a. The heading for *Example 1* is revised.

b. *Example 2* and *Example 3* are redesignated as *Example 3* and *Example 4*, respectively.

c. New *Example 2* is added.

d. The heading of newly designated *Example 4* is revised.

e. *Example 5* is added.

6. Paragraph (i) is added and reserved and paragraph (j) is added.

The additions and revisions read as follows:

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

* * * * *

(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—

* * * * *

(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. * * *

(h) * * *

Example 1. Adjustments to basis of stock for taxable years beginning before January 1, 1997. * * *

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 4. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning before January 1, 1997. * * *

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 and C are affected shareholders because B has transferred shares to Corporation S. Pursuant to section 1377(a)(2)(A) and §1.1377-1(b)(1), B and C, 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)(2), 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)(2), 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 deter-

mined 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.

Par. 6. The first sentence of §1.1367-3 is removed and two sentences are added in its place to read as follows:

§1.1367-3 Effective date and transition rule.

Except for §1.1367-1(f), *Example 2* and *Example 5* of §1.1367-1(h), and §1.1367-1(j), §§1.1367-1 and 1.1367-2 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1367-1(f), *Example 2* and *Example 5* of §1.1367-1(h), and §1.1367-1(j) apply only to taxable years of the corporation beginning on or after August 18, 1998. * * *

Par. 7. Section 1.1368-0 is amended in the table as follows:

1. The entry for §1.1368-1(e) is revised and entries for §1.1368-1(e)(1) and (2) are added.

2. The entries for §1.1368-2(a)(4) and (d) are revised.

3. An entry for §1.1368-2(a)(5) is added.

The additions and revisions read as follows:

§1.1368-0 Table of contents.

* * * * *

§1.1368-1 Distributions by S corporations.

* * * * *

(e) Certain adjustments taken into account.

(1) Taxable years beginning before January 1, 1997.

(2) Taxable years beginning on or after August 18, 1998.

* * * * *

§1.1368-2 Accumulated adjustments account (AAA).

(a) Accumulated adjustments account.

* * * * *

(4) Ordering rules for the AAA for taxable years beginning before January 1, 1997.

(5) Ordering rules for the AAA for taxable years beginning on or after August 18, 1998.

* * * * *

(d) Adjustment in the case of redemptions, liquidations, reorganizations, and divisions.

* * * * *

Par. 8. Section 1.1368-1 is amended by revising paragraphs (d)(1) and (e) to read as follows:

§1.1368-1 Distributions by S corporations.

* * * * *

(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.

* * * * *

(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.

* * * * *

Par. 9. Section 1.1368-2 is amended as follows:

1. Paragraphs (a)(1) and (a)(3)(ii), and the heading and introductory text of paragraph (a)(4) are revised.

2. Paragraph (a)(5) is added.

3. The heading for paragraph (d) is revised.

The additions and revisions read as follows:

§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.

* * * * *

(3) *Decreases to the AAA* * * *

(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, nonde-

ductible 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.

* * * * *

(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—

* * * * *

(5) *Ordering rules for the AAA for taxable years beginning on or after August 18, 1998.* For any taxable year of the 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) of this section for the taxable year;

(ii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368(b) or (c)(1) applies (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)(i) of this section;

(iii) The AAA is decreased under paragraph (a)(3)(i)(C) and (D) of this section before it is decreased under paragraph (a)(3)(i)(A) and (B) of this section;

(iv) The AAA is decreased under paragraph (a)(3)(i)(A) and (B) of this section; and

(v) The AAA is adjusted (whether negative or positive) for redemption distribu-

tions under paragraph (d)(1) of this section.

* * * * *

(d) *Adjustment in the case of redemptions, liquidations, reorganizations, and divisions** * *

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Par. 10. Section 1.1368-3 is amended as follows:

1. The heading for *Example 1* is revised.

2. *Example 2* through *Example 6* are redesignated as *Example 3* through *Example 7*, respectively.

3. New *Example 2* is added.

The revision and addition read as follows:

§1.1368-3 *Examples.*

* * * * *

Example 1. Distributions by S corporations without C corporation earnings and profits for taxable years beginning before January 1, 1997. **

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. 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 de-

scribed 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.

* * * * *

Par. 11. The first sentence of §1.1368-4 is removed and two sentences are added in its place to read as follows:

§1.1368-4 *Effective date and transition rule.*

Except for §§1.1368-1(e)(2), 1.1368-2(a)(5), and *Example 2* of §1.1368-3, §§1.1368-1, 1.1368-2, and 1.1368-3 apply to taxable years of the corporation beginning on or after January 1, 1994. Sections 1.1368-1(e)(2), 1.1368-2(a)(5) and *Example 2* of §1.1368-3 apply only to taxable years of the corporation beginning on or after August 18, 1998. * * *

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Internal Revenue.

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