

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8852]

RIN 1545-AT52

Passthrough of Items of an S Corporation to its Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the passthrough of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment 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 Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Small Business Job Protection Act of 1996. These regulations provide the public with guidance needed to comply with the applicable law and will affect S corporations and their shareholders.

DATES: Effective Date: These regulations are effective August 18, 1998.

Applicability Dates: For dates of applicability, see §1.1366-5, §1.1367-3, and §1.1368-4, plus Transition Rule and Effective Date under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations under section 1366, Martin Schäffer, Deane M. Burke, or David Shulman (202) 622-3070; concerning the regulations under sections

1367 and 1368, Brenda Stewart, (202) 622-3120.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-1613. Responses to this collection of information are mandatory.

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

The burden for this requirement 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".

Suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material 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 amends 26 CFR part 1 to provide additional rules under sections 1366, 1367, and 1368 relating to the passthrough of items of an S corporation to its shareholders, the adjustments to the basis of stock of the shareholders, and the treatment of distributions by an S corporation.

On August 18, 1998, the IRS published in the **Federal Register** (63 FR 44181), a notice of proposed rulemaking (REG-209446-82) regarding sections 1366, 1367, and 1368. Comments responding to the proposed regulations were received. The public hearing was canceled because there were no requests to speak. After considering the comments received, the proposed regulations are adopted as amended by this Treasury decision.

Explanation of Revisions and Summary of Comments

1. Aggregation of deductions from an S corporation with deductions from other sources.

The proposed regulations provide that a shareholder of an S corporation must aggregate its separate deductions and exclusions with the shareholder's pro rata share of the S corporation's separately stated deductions or exclusions in determining the allowable amount of any deduction or exclusion that is subject to a limitation in the Code.

The proposed regulations provide an example of this rule for property expensed under section 179. A commentator suggested that the example implies that a shareholder must expense its pro rata share of section 179 expense from the S corporation before it can expense any separately acquired property.

The example is intended to illustrate that a shareholder may expense only up to the amount allowable under section 179 in any given year regardless of whether the property is owned individually or through an S corporation. The example is not intended to imply that a shareholder must elect to expense property held in an S corporation before it can expense any separately acquired property. However, once an S corporation elects to expense property under section 179, a shareholder will generally elect to expense personal property only to the extent the shareholder's pro rata share of the corporation's section 179 expense does not exceed the shareholder's individual limitation under section 179(b). Accordingly, no modifications have been made to the example in the final regulations.

The commentator also requested that the final regulations provide additional examples that illustrate the aggregation of the shareholder's pro rata share of deductions and exclusions from an S corporation with deductions and exclusions from other sources and the operation of any limitations on those aggregated deductions and exclusions. Specifically, the commentator requested that the final regulations include an example in which the shareholder's aggregate section 179 expenses from several passthrough sources exceeds the maximum section 179 expense allowable. The allocation of the section 179 expense among the various sources is more appropriately addressed in the regulations under section 179 and is beyond the scope of these regulations. Accordingly, the final regulations do not adopt

this comment.

2. Recharacterization of gains and losses at the shareholder level.

Generally, the items of an S corporation that are passed through, and reported by, a shareholder are characterized at the corporate level in the same manner that partnership items are characterized at the partnership level.

However, the proposed regulations also contain exceptions to this general rule for contributions of either noncapital 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 that in the hands of the shareholder or shareholders would have produced a different character of 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.

Commentators suggested that, in the absence of a statutory provision like section 724 in the partnership context, the IRS lacked the authority to recharacterize gain or loss at the shareholder level. Thus, the commentators asserted that the final regulations should not adopt the recharacterization rules. Alternatively, the commentators suggested limiting the recharacterization rule to sales or exchanges occurring within a specified time period.

Unlike the partnership rules, the recharacterization rules

in the proposed regulations are limited to transactions in which an S corporation is used for a principal purpose of changing the character of the gain or loss of contributed property. These rules are reasonable approaches to remedying any improper attempts to utilize section 1366(b) to avoid tax. The length of time between the contribution of the property to the S corporation and the S corporation's sale or exchange of the property will be a factor considered in evaluating whether the S corporation was availed of for a principal purpose of changing the character of the gain or loss. However, the final regulations do not adopt any particular time period. Thus, the final regulations retain the recharacterization rules as proposed.

3. Gross income reporting requirement.

Section 1366(c), like section 702(c) in the partnership context, provides for the passthrough of gross income 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 proposed regulations provide that a 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.

A commentator suggested that the rule in the proposed regulations attempts to narrow the disclosure exception under

section 6501(e) by applying a pro rata concept with respect to a shareholder's gross income. The commentator recommended that the final regulations not adopt the gross income reporting rules or, alternatively, provide a de minimis exception to the rule for certain shareholders who own minority interests in an S corporation.

The rule in the proposed regulations parallels the rules for determining the amount of gross income reported by a partner in a partnership. See section 702(c); §1.702-1(c)(2). Accordingly, the final regulations do not adopt this suggestion.

4. Carryover of disallowed losses under section 1366(d).

Section 1366(d) provides that a shareholder's disallowed losses and deductions for any taxable year shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder. The proposed regulations provide that a shareholder's losses and deductions disallowed under section 1366(d) are personal to the shareholder and cannot in any manner be transferred to another person. A commentator requested that the final regulations provide an exception to this rule for transferees that have an identity of investment interest or common basis with the transferor, such as when stock is transferred incident to divorce under section 1041.

Under section 1366(d), the carryover of disallowed losses and deductions is with respect to the shareholder whose investment limited the items of loss or deduction. Thus, the carryover is not available to a transferee who acquires the stock

whether by sale, death, gift, or otherwise. Accordingly, the final regulations retain the rule that disallowed losses and deductions are nontransferable.

The proposed regulations also provide that if a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed. A commentator suggested that the final regulations permit a former shareholder of an S corporation who subsequently reacquires stock in the S corporation to utilize the losses and deductions previously disallowed to the shareholder.

Losses and deductions that are disallowed in any taxable year carry over under section 1366(d) to the succeeding taxable year of the corporation with respect to a particular shareholder. If a shareholder completely terminates its interest in the corporation, the shareholder will not be a shareholder in the succeeding taxable year of the corporation and the disallowed losses would not carry over. There is no statutory authority for the carryover of disallowed items if a shareholder is not a shareholder in the year succeeding the disallowance. The disallowed items of loss and deduction are amounts that exceed the shareholder's economic investment in the corporation. Once the shareholder terminates its interest in the corporation, it is not necessary to preserve the shareholder's position in the corporation. Thus, the final regulations do not adopt this commentator's suggestion.

5. Basis in S corporation stock received as a gift.

Section 1366(d)(1) limits the amount of corporate losses and deductions that can pass through to, and be deducted by, a shareholder to the shareholder's adjusted basis in the corporation's stock and debt of the corporation to the shareholder.

The proposed regulations provide that, for purposes of section 1366(d)(1), a shareholder's basis in stock acquired by gift is the basis of the stock used for purposes of determining loss under section 1015. Thus, if the fair market value of the stock exceeds the donor's adjusted basis on the date of the gift, for purposes of section 1366(d)(1), the adjusted basis of the stock in the hands of the donee is its adjusted basis in the hands of the donor. However, if the donor's adjusted basis in the stock exceeds the stock's fair market value on the date of the gift, for purposes of section 1366(d)(1), the adjusted basis of the stock in the hands of the donee is the stock's fair market value on the date of the gift.

One commentator argued that the basis for determining loss under section 1015 is applicable only on the disposition of the gifted asset. The basis for determining loss in section 1015 generally does not affect the basis for depreciation or the deductibility of net expenses arising out of the use or operation of the gifted asset.

The proposed regulations, however, apply the loss basis rule in section 1015 not for purposes of determining the depreciable basis of a gifted asset, but rather for purposes of determining

the amount of passthrough losses and deductions (including depreciation deductions and operating losses) that are allowable to a shareholder under section 1366. The donee of loss stock cannot dispose of the stock and recognize the loss inherent in the stock on the date of gift. If the donee could use the donor's basis to take depreciation deductions and operating losses of the S corporation, the donee in effect would realize the benefit of the loss inherent in the stock.

Another commentator agreed that the basis for determining loss in section 1015 ought to be the basis of gifted stock for purposes of section 1366. Thus, the final regulations continue to provide that for purposes of section 1366, the basis of stock acquired by gift is the basis for determining loss under section 1015.

6. Allocation of disallowed losses in certain corporate separations.

The proposed regulations provide rules for the carryover of disallowed losses and deductions in the case of certain corporate reorganizations. 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 356 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 allocated between the distributing corporation and the controlled corporation with respect to the shareholder. The proposed regulations provide that 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.

A commentator suggested that the term value as used in the proposed regulations is ambiguous and that the final regulations should specifically state "fair market value." The commentator also recommended that because the computation of fair market value introduces a host of valuation issues into the transaction, the final regulations should permit an allocation of disallowed losses and deductions based on the relative adjusted bases of the assets of the distributing and controlled corporations. Finally, the commentator requested that the final regulations allow S corporations to allocate disallowed losses and deductions to the controlled or distributing corporation based upon the source of those losses and deductions. The final regulations permit shareholders to allocate disallowed losses and deductions 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 bases 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, a method that allocates such losses and deductions accordingly.

7. Allocation of tax on passive investment income under section 1366(f)(3).

Section 1366(f)(3) provides that if any tax is imposed under section 1375 for a taxable year, each item of passive investment income is reduced by an amount which bears the same ratio to the amount of the tax as the amount of the item bears to the total passive investment income for the taxable year.

A commentator requested guidance in the final regulations on whether the allocation of any tax imposed under section 1375 is made based on the total gross or total net passive investment income. Under section 1375, the amount of excess passive investment income is allocated to the items of passive investment income based on the net passive investment income of the corporation. The allocation of the tax imposed on the excess passive investment income should be similarly allocated. Accordingly, the final regulations clarify that the allocation of any tax under section 1375 is based on the total net passive investment income for the taxable year.

8. Accrual of charitable contribution deductions under section 170(a)(2).

The proposed regulations under section 1366 provide that each shareholder must take into account the shareholder's pro rata share of any charitable contributions paid by the corporation during the corporation's taxable year. A commentator requested that the final regulations clarify that separately stated items include charitable contributions paid or deemed to be paid. The commentator suggested that an accrual basis S corporation may elect under section 170(a)(2) to treat charitable contributions as paid in the year prior to the year in which the charitable contribution is actually paid.

Under section 1363(b), S corporations generally compute their taxable income in the same manner as in the case of an individual. However, S corporations are not permitted to take charitable contribution deductions by virtue of the cross reference in section 1363(b)(2) to section 703(a)(2). Instead, the deductions for charitable contributions pass through to the shareholders of the S corporation. Individuals cannot make the election under section 170(a)(2). Treasury and the Service believe that an S corporation also cannot make the election under section 170(a)(2). Accordingly, the final regulations do not adopt this suggestion.

9. Treatment of section 108 income

The regulations enumerate items of income (including tax-exempt income), loss, deduction, or credit of an S corporation

that must be taken into account separately by each shareholder pursuant to section 1366(a)(1)(A). "Tax-exempt income" does not include income from discharge of indebtedness excluded from income under section 108 because such income is not permanently excludible from income in all circumstances in which section 108 applies. One commentator objected to this treatment of section 108 income, arguing that such income is tax-exempt and that application of section 108 at the S corporation level pursuant to section 108(d)(7)(A) does not preclude the pass-through of section 108 income. Another commentator, however, agreed with the approach taken by the regulations.

Treasury and the Service continue to believe that 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 the specific rules that apply to the discharge of indebtedness income of S corporations. Accordingly, the treatment of section 108 income is unchanged in the final regulations.

10. Adjustment to Basis of Stock

Section 1367(a) and §1.1367-1 of the proposed regulations prescribe the order of 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.

A commentator suggested that the final regulations should provide that life insurance premiums on policies owned by the S

corporation do not affect either a shareholder's basis in stock/debt or the corporation's accumulated adjustments account (AAA). The commentator further suggested that §1.1367-1(c)(2) (relating to noncapital, nondeductible expenses) be amended to make special provision for accounts receivable when debt is restored.

Because these comments relate to provisions in §1.1367-1 that were not affected by the amendments contained in the proposed regulations, the comments are not reflected in the final regulations.

11. Adjustments Required Before Determining Tax Effect of Distribution.

Section 1.1368-2 of the proposed regulations 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 to the shareholders for taxable years of the corporation beginning on or after August 18, 1998.

One commentator interpreted §1.1368-2(a)(5) of the proposed regulations, which prescribes the order in which adjustments are made to the AAA for purposes of determining the source of a distribution, as providing that the AAA is adjusted in the same order as the adjustments to the basis of a share of stock under §1.1367-1 of the proposed regulations. The commentator stated that although the Small Business Job Protection Act of 1996 (1996 Act) changed the order of the adjustments to the basis of a share of stock, the 1996 Act did not change the order of the

adjustments to the AAA except in situations involving a net negative adjustment (where the reductions in the account for the taxable year exceed the increases for the taxable year). When a net negative adjustment occurs, the AAA is adjusted to take into account distributions before the AAA is adjusted to take into account any net negative adjustment.

Consistent with the comment received, the final regulations make clear that except in situations involving a net negative adjustment, the order of adjustments to the AAA is not changed. Examples are added to the final regulations to illustrate the effect of the 1996 Act on the AAA ordering rules.

12. Transition Rule and Effective Date sections 1367 and 1368.

Sections 1.1367-3 and 1.1368-4 of the proposed regulations provide that the amendments to the final regulations under section 1367 and 1368 apply only to taxable years of the corporation beginning on or after August 18, 1998.

Commentators suggested that because the amendments to sections 1367 and 1368 under the 1996 Act are effective for taxable years beginning after December 31, 1996, the final regulations should be effective, at least on an elective basis, for the period beginning from the effective date of the 1996 Act and ending on the effective date of the final regulations.

Sections 1.1367-3 and 1.1368-4 of the final regulations reflect this comment and provide that for taxable years beginning on or after January 1, 1997, and before August 18, 1998, the adjustments to the basis of a shareholder's stock and the

treatment of distributions by an S corporation, respectively, must be determined in a reasonable manner, taking into account the statute and the legislative history. Return positions consistent with the final regulations will be considered reasonable.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these final regulations are

Terri A. Belanger, Deane M. Burke, 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.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

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

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

Par. 2. Sections 1.1366-0 and 1.1366-1 are added, §1.1366-2 is revised, and §§1.1366-3 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 noncapital 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 passthrough 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 passthrough of certain items of an S corporation to its shareholders.

- (a) Passthrough inapplicable to section 34 credit.
- (b) Reduction in passthrough for tax imposed on built-in gains.
- (c) Reduction in passthrough 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 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).

§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)(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 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)(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(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 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.

§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.

§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 amount of the item bears to the total net 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. 3. 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. 4. Section 1.1367-1 is amended as follows:

1. The paragraph 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, in the succeeding taxable year. * * *

(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 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.

Par. 5. §1.1367-3 is revised to read as follows:

§1.1367-3 Effective date and transition rule.

Except for §1.1367-1(f), (h) Example 2 and Example 5, and (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), (h) Example 2 and Example 5, and (j) 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 basis of a shareholder's stock must be determined in a reasonable manner, taking into account the statute and legislative history. Except for §1.1367-1(f), (h) Example 2 and Example 5, and (j), return positions consistent with §§1.1367-1 and 1.1367-2 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with §1.1367-1(f), (h) Example 2 and Example 5, and (j) are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

Par. 6. 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 entry for §1.1368-2(a)(4) is revised.
3. An entry for §1.1368-2(a)(5) is added.
4. The entry for §1.1368-2(d) is revised.

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) * * *

(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. 7. 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. 8. Section 1.1368-2 is amended as follows:

1. Paragraphs (a)(1) and (a)(3)(ii), and the paragraph heading and introductory text of paragraph (a)(4) are revised.
2. Paragraph (a)(5) is added.
3. The paragraph 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) * * *

(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.

* * * * *

(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 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.

* * * * *

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

* * * * *

Par. 9. Section 1368-3 is amended as follows:

1. The heading for Example 1 is revised.
2. Example 3 through Example 6 are redesignated as Example 6 through Example 9, respectively.
3. Example 2 is redesignated as Example 3.
4. The heading for newly redesignated Example 3 is revised.
5. New Example 2, Example 4, and Example 5 are added.

The revisions and additions 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. 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 ($\$38 \text{ distribution}/10 \text{ shares}$). 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 \text{ 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 \text{ items described in section } 1367(a)(2)(B) \text{ and } (C)/10 \text{ 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. * * *

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 ($\$20 + \$20 (\$2,000 \text{ income}/100 \text{ shares}) - \$15 (\$1,500 \text{ distribution}/100 \text{ shares}) - \$15 (\$1,500 \text{ loss}/100 \text{ shares})$).

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 \text{ income} - \$20 \text{ 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.

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Par. 10. §1.1368-4 is revised 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 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.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for part 602 continues to

read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. In §602.101, paragraph (b) is amended by adding the entry for 1.1366-1 to the table as follows:

§602.101 OMB Control numbers.

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(b) * * *

<u>CFR part or section where identified and described</u>	<u>Current OMB control No.</u>
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1.1366-1.....	1545-1613
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Deputy Commissioner of Internal Revenue

Robert E. Wenzel

Approved: December 13, 1999

Acting Assistant Secretary of the Treasury

Jonathan Talisman