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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9180

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Adjustment to Net Unrealized Built-in Gain

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1374 that provide for an adjustment to the amount that may be subject to tax under section 1374 in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which section 1374(d)(8) applies. These final regulations provide guidance to certain S corporations that acquire assets from a C corporation in a carryover basis transaction.

DATES: Effective Date: These regulations are effective February 23, 2005.

Applicability Dates: For dates of applicability, see §1.1374-10.

FOR FURTHER INFORMATION CONTACT: Jennifer D. Sledge, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains amendments to Income Tax Regulations (26 CFR part 1) under section 1374 of the Internal Revenue Code, relating to the tax imposed on certain recognized built-in gains of S corporations. Section 1374 imposes a tax on an S

corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation for the 10-year period beginning on the first day the corporation is an S corporation and assets that it acquired from a C corporation in a carryover basis transaction for the 10-year period beginning on the day of the acquisition. A separate determination of the amount subject to tax under section 1374 is required for those assets the S corporation held on the date it converted to C status and each pool of assets the S corporation acquired in a carryover basis transaction from a C corporation. The total amount subject to tax under section 1374 for each pool of assets is limited to that pool's net unrealized built-in gain (NUBIG) on the date of the conversion or acquisition.

Under the current rules, if X, a C corporation, elects to be an S corporation when it owns some or all of the stock of Y, a C corporation, and Y subsequently transfers its assets to X in a liquidation to which sections 332 and 337(a) apply or in a reorganization described in section 368(a), the built-in gain or built-in loss in Y's assets may be wholly or partially reflected twice: once in the NUBIG attributable to the assets X owned on the date of its conversion (including the Y stock) and a second time in the NUBIG attributable to Y's former assets acquired by X in the liquidation of Y. The IRS and Treasury Department recognize that continuing to reflect the built-in gain or the built-in loss in the Y stock at the time of X's conversion after the liquidation or reorganization is inconsistent with the fact that such liquidation or reorganization has the effect of eliminating that built-in gain or built-in loss. Therefore, on June 25, 2004, the IRS and Treasury Department published in the **Federal Register** (69 FR 35544) a notice of proposed rulemaking (REG-131486-03) that includes regulations proposing an adjustment to the NUBIG in these

cases. In particular, the proposed regulations generally provide that, if an S corporation acquires assets of a C corporation in a carryover basis transaction, some or all of the stock of the C corporation from which such assets were acquired was taken into account in the computation of NUBIG for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to certain limitations, such NUBIG is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled stock had on the initial computation of NUBIG for that pool of assets. These regulations are proposed to apply for taxable years beginning after the date they are published as final regulations in the Federal Register.

No public hearing was requested or held regarding the proposed regulations. One written comment, however, was received. That comment requested that the proposed regulations be made effective as soon as possible.

These final regulations adopt the proposed regulations without substantive change as final regulations. However, the final regulations do modify the proposed effective date of the regulations. The final regulations apply to section 1374(d)(8) transactions that occur in taxable years beginning after February 23, 2005. The final regulations also provide that an S corporation may apply the regulations to section 1374(d)(8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended returns that are consistent with the regulations for taxable years of the S corporation during the recognition period of the pool of assets the NUBIG of which would be adjusted pursuant to the regulations that are not closed as of

the first date after February 23, 2005 that the S corporation files an original or amended return.

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 also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Jennifer D. Sledge of the Office of Associate Chief Counsel (Corporate). Other personnel from Treasury and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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. Section 1.1374-3 is amended by:

1. Revising paragraph (b).

2. Adding paragraph (c).

The revision and addition read as follows:

§1.1374-3 Net unrealized built-in gain.

* * * * *

(b) Adjustment to net unrealized built-in gain - - (1) In general. If section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (b)(2) of this section, such net unrealized built-in gain is adjusted to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

(2) Limitations on adjustment - - (i) Recognized built-in gain or loss. Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

(ii) Anti-duplication rule. Paragraph (b)(1) of this section shall not be applied to duplicate an adjustment to the net unrealized built-in gain for a pool of assets made pursuant to paragraph (b)(1) of this section.

(3) Effect of adjustment. Any adjustment to the net unrealized built-in gain made pursuant to this paragraph (b) only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the acquisition to which section 1374(d)(8) applies.

(4) Pool of assets. For purposes of this section, a pool of assets means --

(i) The assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or

(ii) The assets the S corporation acquired from a C corporation in a section 1374(d)(8) transaction.

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

Example 1. Computation of net unrealized built-in gain. (i)(A) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory	\$500,000	\$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000
Liabilities	Amount	
Mortgage	\$200,000	
Accounts Payable	100,000	
Total	300,000	

(B) Further, X must include a total of \$60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be \$1,050,000 (\$750,000 cash received + \$300,000 liabilities assumed = \$1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized	\$1,050,000
Deduction allowed (A/P)	(100,000)
Basis of X's assets	(900,000)
Section 481 adjustments	60,000
 Net unrealized built-in gain	 110,000

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of \$15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of \$33,000 and an adjusted basis of \$18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has \$10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X's taxable income limitation for 2009 is \$50,000. Effective June 1, 2009, X elects under section 1361 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y's assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by \$15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is \$0.

(iii) Under §1.1374-2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is \$10,000, X's taxable income limitation is \$50,000, and X's net unrealized built-in gain limitation is \$0. Because the net unrealized built-in gain of the first pool of assets has been adjusted to \$0, despite the \$10,000 of recognized built-in gain in 2009, X has \$0 net recognized built-in gain for the taxable year ending on December 31, 2009.

Example 3. Adjustment to net unrealized built-in gain for built-in loss in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of negative \$5,000. Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of \$18,000 and an adjusted basis of \$33,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, resulting in \$8,000 of recognized built-in gain. X has

had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is \$50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the reorganization. The net unrealized built-in gain of the first pool of assets, therefore, is increased by \$15,000, the amount by which the adjusted basis of the Y stock exceeded its fair market value as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is \$10,000.

(iii) Under §1.1374-2(a), X's net recognized built-in gain for any taxable year equals the least of X's pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X's pre-limitation amount is \$8,000 and X's taxable income limitation is \$50,000. The net unrealized built-in gain of the first pool of assets has been adjusted to \$10,000, so X's net unrealized built-in gain limitation is \$10,000. X, therefore, has \$8,000 net recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is \$2,000.

Example 4. Adjustment to net unrealized built-in gain in case of prior gain recognition. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of \$30,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of \$45,000 and an adjusted basis of \$10,000. Y has no current or accumulated earnings and profits. On April 1, 2007, Y distributes \$18,000 to X, \$8,000 of which is treated as gain to X from the sale or exchange of property under section 301(c)(3). That \$8,000 is recognized built-in gain to X under section 1374(d)(3), and results in \$8,000 of net recognized built-in gain to X for 2007. X's net unrealized built-in gain limitation for 2008 is \$22,000. On June 1, 2009, Y transfers its assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built in-gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of that pool of assets, however, can only be adjusted to reflect the amount of built-in gain that was inherent in the Y stock on January 1, 2005 that has not resulted in recognized built-in gain during the recognition period. In this case, therefore, the net unrealized built-in gain of the first pool of assets cannot be reduced by more than \$27,000 (\$35,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005, minus \$8,000, the recognized built-in gain with respect to the stock during the recognition period). Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is \$3,000. The net unrealized built-in gain limitation for 2009 is \$0.

Par. 3. Paragraph (a) of §1.1374-10 is revised to read as follows:

§1.1374-10 Effective date and additional rules.

(a) In general. Sections 1.1374-1 through 1.1374-9, other than §1.1374-3(b) and (c) Examples 2 through 4, apply for taxable years ending on or after December 27, 1994, but only in cases where the S corporation's return for the taxable year is filed pursuant to an S election or a section 1374(d)(8) transaction occurring on or after December 27, 1994. Section 1.1374-3(b) and (c) Examples 2 through 4 apply to section 1374(d)(8) transactions that occur in taxable years beginning after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. In addition, an S corporation may apply §1.1374-3(b) and (c) Examples 2 through 4 to section 1374(d)(8) transactions that occur in taxable years beginning on or before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended returns that are consistent with these provisions for taxable years of the S corporation during the recognition period of the pool of assets the net unrealized built-in gain of which would be adjusted pursuant to those provisions that are not closed as of the first date after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]** that the S corporation files an original or amended return. For purposes of this section, affected shareholders means all shareholders who received distributive shares of S corporation items in such taxable years. However, the Commissioner may, in appropriate circumstances, permit taxpayers to apply these provisions even if all affected shareholders cannot file consistent returns. In addition, for this purpose, a predecessor of an S corporation is a corporation that transfers its assets

to the S corporation in a

transaction to which section 381 applies. A successor of an S corporation is a corporation to which the S corporation transfers its assets in a transaction to which section 381 applies.

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Deputy Commissioner for Services and Enforcement.

Approved:

Assistant Secretary of the Treasury.