

this section, the total amount of section 1254 costs with respect to the parcels is allocated to the parcels in proportion to their respective adjusted bases.

(e) *Property transferred in cases to which section 1071 or 1081(b) applies.* Rules similar to the rules of section 1245(b)(5) shall apply under section 1254.

[T.D. 8586, 60 FR 2506, Jan. 10, 1995, as amended by T.D. 8684, 61 FR 53063, Oct. 10, 1996]

**§ 1.1254-4 Special rules for S corporations and their shareholders.**

(a) *In general.* This section provides rules for applying the provisions of section 1254 to S corporations and their shareholders upon the disposition by an S corporation (and a corporation that was formerly an S corporation) of natural resource recapture property and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.

(b) *Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation—(1) General rule.* Upon a disposition of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under section 1254 is determined at the shareholder level. Each shareholder must recognize as ordinary income under section 1254 the lesser of—

(i) The shareholder's section 1254 costs with respect to the property disposed of; or

(ii) The shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

*Example 1. Disposition of natural resource recapture property other than oil and gas property.* A and B are equal shareholders in X, an S corporation. On January 1, 1997, X acquires for \$90,000 an undeveloped mineral property, its sole property. During 1997, X expends and deducts \$100,000 in developing the property. On January 15, 1998, X sells the property for

\$250,000 when X's basis in the property is \$90,000. Thus, X recognizes gain of \$160,000 on the sale. A and B's share of the \$160,000 gain recognized is \$80,000 each. Each shareholder has \$50,000 of section 1254 costs with respect to the property. Under these circumstances, A and B each are required to recognize \$50,000 of the \$80,000 of gain on the sale of the property as ordinary income under section 1254.

*Example 2. Disposition of oil and gas property the adjusted basis of which is allocated to the shareholders under section 613A(c)(11).* C and D are equal shareholders in Y, an S corporation. On January 1, 1997, Y acquires for \$150,000 an undeveloped oil and gas property, its sole property. During 1997, Y expends in developing the property \$40,000 in intangible drilling costs which it elects to expense under section 263(c). On January 15, 1998, Y sells the property for \$200,000. C and D's share of the \$200,000 amount realized on the sale is \$100,000 each. C and D each have a basis of \$75,000 in the property and \$20,000 of section 1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize \$20,000 of the \$25,000 gain on the sale of the property as ordinary income under section 1254.

(c) *Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock—(1) General rule.* Except as provided in paragraph (c)(2) of this section, if an S corporation shareholder recognizes gain upon a sale or exchange of stock in the S corporation (determined without regard to section 1254), the gain is treated as ordinary income under section 1254 to the extent of the shareholder's section 1254 costs (with respect to the shares sold or exchanged).

(2) *Exceptions—(i) Gain not attributable to section 1254 costs—(A) General rule.* Paragraph (c)(1) of this section does not apply to any portion of the gain recognized on the sale or exchange of the stock that the taxpayer establishes is not attributable to section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the

shareholder of ordinary income under section 1254.

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)(2)(i)(A) of this section, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section 1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock.

This reduced amount realized is used in determining any gain or loss on the sale or exchange.

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

*Example 1. Application of general rule upon a sale of S corporation stock.* C and D are equal shareholders in Y, an S corporation. As of January 1, 1997, Y holds two mining properties: Blackacre, with an adjusted basis of \$5,000 and a fair market value of \$35,000, and Whiteacre, with an adjusted basis of \$20,000 and a fair market value of \$15,000. Y also holds securities with a basis of \$5,000 and a fair market value of \$10,000. On January 1, 1997, D sells 50 percent of D's Y stock to E for \$15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is \$7,500, and D has \$18,000 of section 1254 costs with respect to Blackacre and \$12,000 of section 1254

costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize \$7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in ordinary income to D under section 1254), the \$7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes \$7,500 of ordinary income under this paragraph (c).

*Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs.* Assume the same facts as in *Example 1*, except that Blackacre has a fair market value of \$25,000, and the securities have a fair market value of \$20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize \$5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1997 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the \$7,500 gain recognized by D, \$5,000 is ordinary income under this paragraph (c).

*Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to avoid recognition of ordinary income under section 1254.* H owns all of the stock of Z, an S corporation. As of January 1, 1997, H has \$3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of \$5,000 and a fair market value of \$8,000. H has a basis of \$5,000 in Z stock, which has a fair market value of \$8,000. On January 1, 1997, H contributes securities to Z which have a basis of \$7,000 and a fair market value of \$4,000. On April 15, 1997, H sells all of the Z stock to J for \$12,000. On that date, H's adjusted basis in the Z stock is also \$12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph (c)(2)(ii) of this section, H must recognize \$3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock (\$12,000) by \$3,000. As a result, H also recognizes a \$3,000 capital loss on the sale of

the stock (\$9,000 amount realized less \$12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* An S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property in the hands of the S corporation. See § 1.1254-1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions—(1) Basis determined under section 1012.* If stock in an S corporation that holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined under section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined under section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a

gift, in a transfer that is a part sale or exchange and part gift, or in a transfer that is described in section 1041(a), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for a corporation that was formerly an S corporation or formerly a C corporation—(1) Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a pro rata share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

(2) *Examples.* The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

*Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i)* Y is a C corporation that elects to be an S corporation effective January 1, 1997. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of \$20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1997, Oil Well has a value of \$200,000 and a basis of \$100,000. Thus, under section 1374, Y's net unrealized built-in gain is \$100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under paragraph (f)(1) of this section. In addition, A has a basis in A's Y stock of \$100,000.

(ii) On November 1, 1997, Y sells Oil Well for \$250,000. During 1997, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital

loss under section 1366(f)(2). A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of \$20,000 and net capital gain of \$95,000 (\$130,000 minus \$35,000) on the sale.

*Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation—*(i) Assume the same facts as in *Example 1*(i). On November 1, 1997, A sells all of A's Y stock to P for \$250,000. A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain.

(ii) On November 2, 1997, Y sells Oil Well for \$250,000. During 1997, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000), which is recognized as capital gain. Consequently, P recognizes net capital gain of \$115,000 (\$150,000 minus \$35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an S corporation.* In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year that the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions—*(1) *Issuance of stock.* Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization described in section 368 or otherwise—

(i) Each recipient of shares must be allocated a pro rata share (determined solely with respect to the shares issued in the transaction) of the aggregate of the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs immediately before the issuance multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock.* If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to its shareholders a pro rata share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under § 1.1254-3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of § 1.83-3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation—*(i) *In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(ii)

(written data) or paragraph (g)(5)(iii) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(ii) of this section and of others under paragraph (g)(5)(iii) of this section.

(ii) *Written data.* An S corporation may determine a shareholder's section 1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(iii) of this section in determining a shareholder's section 1254 costs.

(iii) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(ii) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs—

(A) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(B) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

*Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction.* As of January 1, 1997, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of \$2,000 and an adjusted basis of \$2,000. On January 1, 1997, B transfers

natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of \$8,000 and an adjusted basis of \$5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled \$6,000. Under § 1.1254-2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under § 1.1254-3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal \$6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a pro rata share of X's section 1254 costs. The pro rata share of X's section 1254 costs that is allocated to A equals \$1,200 (20 percent interest in X multiplied by X's \$6,000 of section 1254 costs). The pro rata share of X's section 1254 costs that is allocated to B equals \$4,800 (80 percent interest in X multiplied by X's \$6,000 of section 1254 costs).

*Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property.* As of January 1, 1997, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of \$20,000 and an adjusted basis of \$14,000. A's and B's section 1254 costs with respect to Property P are \$4,000 and \$1,500, respectively. On January 1, 1997, C contributes \$20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a pro rata share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(iii) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal \$4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal \$1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals \$6,000. C's pro rata share of the \$6,000 of section 1254 costs equals \$3,000 (C's 50 percent interest in X multiplied by \$6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by \$2,000 (A's actual section 1254 costs (\$4,000) multiplied by 50 percent). B's section 1254 costs are reduced by \$750 (B's actual section 1254 costs (\$1,500) multiplied by 50 percent).

*Example 3. Merger involving an S corporation that holds natural resource recapture property.* X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of \$120,000 and an adjusted basis of \$40,000. A has section 1254 costs with respect to the property of \$60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds

property that is not natural resource recapture property that has a fair market value of \$120,000 and basis of \$120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a pro rata share of its \$60,000 of section 1254 costs. Thus, A and B are each allocated \$30,000 of section 1254 costs (50 percent interest in X, each, multiplied by \$60,000).

[T.D. 8684, 61 FR 53063, Oct. 10, 1996]

**§ 1.1254-5 Special rules for partnerships and their partners.**

(a) *In general.* This section provides rules for applying the provisions of section 1254 to partnerships and their partners upon the disposition of natural resource recapture property by the partnership and certain distributions of property by a partnership. See section 751 and the regulations thereunder for rules concerning the treatment of gain upon the transfer of a partnership interest.

(b) *Determination of gain treated as ordinary income under section 1254 upon the disposition of natural resource recapture property by a partnership—(1) General rule.* Upon a disposition of natural resource recapture property by a partnership, the amount treated as ordinary income under section 1254 is determined at the partner level. Each partner must recognize as ordinary income under section 1254 the lesser of—

(i) The partner's section 1254 costs with respect to the property disposed of; or

(ii) The partner's share of the amount, if any, by which the amount realized upon the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition, exceeds the adjusted basis of the property.

(2) *Exception to partner level recapture in the case of abusive allocations.* Paragraph (b)(1) of this section does not apply in determining the amount treated as ordinary income under section 1254 upon a disposition of section 1254 property by a partnership if the partnership has allocated the amount realized or gain recognized from the disposition with a principal purpose of avoiding the recognition of ordinary

income under section 1254. In such case, the amount of gain on the disposition recaptured as ordinary income under section 1254 is determined at the partnership level.

(3) *Examples.* The provisions of paragraphs (a) and (b) of this section are illustrated by the following examples which assume that capital accounts are maintained in accordance with section 704(b) and the regulations thereunder:

*Example 1. Partner level recapture—*In general, A, B, and C, have equal interests in capital in Partnership ABC that was formed on January 1, 1985. The partnership acquired an undeveloped domestic oil property on January 1, 1985, for \$120,000. The partnership allocated the property's basis to each partner in proportion to the partner's interest in partnership capital, so each partner was allocated \$40,000 of basis. In 1985, the partnership incurred \$60,000 of productive well intangible drilling and development costs with respect to the property. The partnership elected to deduct the intangible drilling and development costs as expenses under section 263(c). Each partner deducted \$20,000 of the intangible drilling and development costs. Assume that depletion allowable under section 613A(c)(7)(D) for each partner for 1985 was \$10,000. On January 1, 1986, the partnership sold the oil property to an unrelated third party for \$210,000. Each partner's allocable share of the amount realized is \$70,000. Each partner's basis in the oil property at the end of 1985 is \$30,000 (\$40,000 cost—\$10,000 depletion deductions claimed). Each partner has a gain of \$40,000 on the sale of the oil property (\$70,000 amount realized—\$30,000 adjusted basis in the oil property). Assume that each partner's depletion allowance would not have been increased if the intangible drilling and development costs had been capitalized. Each partner's section 1254 costs with respect to the property are \$20,000. Thus, A, B, and C each must treat \$20,000 of gain recognized as ordinary income under section 1254(a).

*Example 2. Special allocation of intangible drilling and development costs.* K and L form a partnership on January 1, 1997, to acquire and develop a geothermal property as defined under section 613(e)(2). The partnership agreement provides that all intangible drilling and development costs will be allocated to partner K, and that all other items of income, gain, or loss will be allocated equally between the two partners. Assume these allocations have substantial economic effect under section 704(b) and the regulations thereunder. The partnership acquires a lease covering undeveloped acreage located in the United States for \$50,000. In 1997, the partnership incurs \$50,000 of intangible drilling and