

following these regulations is a reasonable return position. See Notice 92-56, 1992-49 I.R.B. (see § 601.601(d)(2)(ii)(b) of this chapter), for additional guidance regarding reasonable return positions for years to which §§ 1.1362-1 through 1.1362-6 do not apply.

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

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

§ 1.1362-8 Dividends received from affiliated subsidiaries.

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

(b) *Determination of active or passive earnings and profits—(1) In general.* An S corporation may use any reasonable method to determine the amount of

dividends that are not treated as passive investment income under section 1362(d)(3)(E). Paragraph (b)(5) of this section describes a method of determining the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E) that is deemed to be reasonable under all circumstances.

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

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

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

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

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

(2) *Distributions from accumulated earnings and profits.* Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

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

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

(i) The current earnings and profits, accumulated earnings and profits, and active earnings and profits of the common parent shall be determined under the principles of § 1.1502-33 (relating to earnings and profits of any member of

a consolidated group owning stock of another member); and

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

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

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

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

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

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

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

purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

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

§ 1.1363-1 Effect of election on corporation.

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

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

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

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

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

(ii) Each shareholder may elect to amortize that shareholder's pro rata share of any qualified expenditure de-

scribed in section 59(e) paid or accrued by the S corporation.

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

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

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

§ 1.1363-2 Recapture of LIFO benefits.

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

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

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

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

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

(b) *Payment of tax.* Any increase in tax caused by including the LIFO recapture amount in the gross income of