

## § 1.1366-4

## 26 CFR Ch. I (4-1-02 Edition)

into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999]

### § 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 net amount of the item bears to the total net passive investment income for that taxable year.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000]

### § 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.

[T.D. 8852, 64 FR 71648, Dec. 22, 1999]

### § 1.1367-0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1367-1 through 1.1367-3.

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

- (a) In general.
- (1) Adjustments under section 1367.

(2) Applicability of other Internal Revenue Code provisions.

(b) Increase in basis of stock.

(1) In general.

(2) Amount of increase in basis of individual shares.

(c) Decrease in basis of stock.

(1) In general.

(2) Noncapital, nondeductible expenses.

(3) Amount of decrease in basis of individual shares.

(d) Time at which adjustments to basis of stock are effective.

(1) In general.

(2) Adjustment for nontaxable item.

(3) Effect of election under section 1377(a)(2) or § 1.1368-1(g)(2).

(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.

*§ 1.1367-2 Adjustments to basis of indebtedness to shareholder.*

(a) In general.

(b) Reduction in basis of indebtedness.

(1) General rule.

(2) Termination of shareholder's interest in corporation during taxable year.

(3) Multiple indebtedness.

(c) Restoration of basis.

(1) General rule.

(2) Multiple indebtedness.

(d) Time at which adjustments to basis of indebtedness are effective.

(1) In general.

(2) Effect of election under section 1377(a)(2) or § 1.1368-1(g)(2).

(e) Examples.

*§ 1.1367-3 Effective date and transition rule.*

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999]

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

(a) *In general*—(1) *Adjustments under section 1367.* This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) *Applicability of other Internal Revenue Code provisions.* In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) *Increase in basis of stock*—(1) *In general.* Except as provided in § 1.1367-2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) *Amount of increase in basis of individual shares.* The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) *Decrease in basis of stock*—(1) *In general.* The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) *Noncapital, nondeductible expenses.* For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (*noncapital, nondeductible expenses*) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating

antitrust laws not deductible under section 162.

(3) *Amount of decrease in basis of individual shares.* The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) *Time at which adjustments to basis of stock are effective*—(1) *In general.* The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) *Adjustment for nontaxable item.* An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for Federal income tax purposes if the item had been subject to Federal income taxation.

(3) *Effect of election under section 1377(a)(2) or § 1.1368-1(g)(2).* If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under § 1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest is terminated or a qualifying disposition occurs, whichever the case may be.

(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—

(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 noncapital, nondeductible expenses described in section 1367(a)(2)(D) and the oil and gas depletion deduction described in section 1367(a)(2)(E);

(3) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2) (B) and (C); and

(4) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A).

(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. A shareholder makes the

election under this paragraph by attaching a statement to the shareholder's timely filed original or amended return that states that the shareholder agrees to the carryover rule of the preceding sentence. Once a shareholder makes an election under this paragraph with respect to an S corporation, the shareholder must continue to use the rules of this paragraph for that S corporation in future taxable years unless the shareholder receives the permission of the Commissioner.

(h) *Examples.* The following examples illustrate the principles of § 1.1367-1. In each example, the corporation is a calendar year S corporation:

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

(i) On December 31, 1994, A owns a block of 50 shares of stock with an adjusted basis per share of \$6 in Corporation S. On December 31, 1994, 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 1995 taxable year. For S's 1995 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is \$300, and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) and (D) (relating to decreases in basis of stock) is \$500. S makes a distribution to A in the amount of \$100 during 1995.

(ii) Pursuant to the ordering rules of paragraph (e) of this section, A increases the basis of each share of stock by \$3 (\$300/100 shares) and decreases the basis of each share of stock by \$5 (\$500/100 shares). Then A reduces the basis of each share by \$1 (\$100/100 shares) for the distribution. Thus, on January 1, 1996, A has a basis of \$3 per share in his original block of 50 shares (\$6+\$3-\$5-\$1) and a basis of \$5 per share in the second block of 50 shares (\$8+\$3-\$5-\$1).

*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.

(i) 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 3. Adjustments attributable to basis of individual shares of stock.* (i) On December 31, 1993, B owns one share of S corporation's

10 outstanding shares of stock. The basis of B's share is \$30. On July 2, 1994, B purchases from another shareholder two shares for \$25 each. During 1994, S corporation has no income or deductions but incurs a loss of \$365. Under section 1377(a)(1)(A) and paragraph (c)(3) of this section, the amount of the loss assigned to each day of S's taxable year is \$1.00 (\$365/365 days). For each day, \$.10 is allocated to each outstanding share (\$1.00 amount of loss assigned to each day/10 shares).

(ii) B owned one share for 365 days and, therefore, reduces the basis of that share by the amount of loss attributable to it, i.e., \$36.50 (\$.10 × 365 days). B owned two shares for 182 days and, therefore, reduces the basis of each of those shares by the amount of the loss attributable to each, i.e., \$18.20 (\$.10 × 182 days).

(iii) The bases of the shares are decreased as follows:

| Share                       | Original basis | Decrease | Adjusted basis | Excess basis reduction |
|-----------------------------|----------------|----------|----------------|------------------------|
| No. 1 .....                 | \$30.00        | \$36.50  | \$0            | \$6.50                 |
| No. 2 .....                 | 25.00          | 18.20    | 6.80           | 0                      |
| No. 3 .....                 | 25.00          | 18.20    | 6.80           | 0                      |
| Total remaining basis ..... | .....          | .....    | 13.60          | .....                  |

(iv) Because the decrease in basis attributable to share No. 1 exceeds the basis of share No. 1 by \$6.50 (\$36.50 - \$30.00), the excess is applied to reduce the bases of shares No. 2 and No. 3 in proportion to their remaining bases. Therefore, the bases of share No. 2 and share No. 3 are each decreased by an additional \$3.25 (\$6.50 × \$6.80/\$13.60). After this decrease, Share No. 1 has a basis of zero, Share No. 2 has a basis of \$3.55, and Share No. 3 has a basis of \$3.55.

*Example 4. Effects of section 1377(a)(2) election and distribution on basis of stock for taxable years beginning before January 1, 1997.* (i) On January 1, 1994, individuals B and C each own 50 of the 100 shares of issued and outstanding stock of Corporation S. B's adjusted basis in each share of stock is \$120, and C's is \$80. On June 30, 1994, S distributes \$6,000 to B and \$6,000 to C. On June 30, 1994, B sells all of her S stock for \$10,000 to D. S elects under section 1377(a)(2) to treat its 1994 taxable year as consisting of two taxable years, the first of which ends at the close of June 30, the date on which B terminates her interest in S.

(ii) For the period January 1, 1994, through June 30, 1994, S has nonseparately computed income of \$6,000 and a separately stated deduction item of \$4,000. Therefore, on June 30, 1994, B and C, pursuant to the ordering rules of paragraph (e) of this section, increase the basis of each share by \$60 (\$6,000/100 shares)

and decrease the basis of each share by \$40 (\$4,000/100 shares). Then B and C reduce the basis of each share by \$120 (\$12,000/100 shares) for the distribution.

(iii) The basis of B's stock is reduced from \$120 to \$20 per share (\$120+\$60-\$40-\$120). The basis of C's stock is reduced from \$80 to \$0 per share (\$80+\$60-\$40-\$120). See section 1368 and § 1.1368-1 (c) and (d) for rules relating to the tax treatment of the distributions.

(iv) Pursuant to paragraph (d)(3) of this section, the net reduction in the basis of B's shares of the S stock required by section 1367 and this section is effective immediately prior to B's sale of her stock. Thus, B's basis for determining gain or loss on the sale of the S stock is \$20 per share, and B has a gain on the sale of \$180 (\$200 - \$20) per share.

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

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000; 65 FR 16319, Mar. 28, 2000]

**§ 1.1367-2 Adjustments to basis of indebtedness to shareholder.**

(a) *In general.* This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness of an S corporation to a shareholder. For purposes of this section,

shareholder advances not evidenced by separate written instruments and repayments on the advances (*open account debt*) are treated as a single indebtedness. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section.

(b) *Reduction in basis of indebtedness—*  
(1) *General rule.* If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2) (B), (C), (D), and (E) (relating to losses, deductions, noncapital, non-deductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) *Termination of shareholder's interest in corporation during taxable year.* If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) *Multiple indebtedness.* If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) *Restoration of basis—*(1) *General rule.* If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any *net increase* in