

amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose, as determined under paragraph (b) of this section.

(d) *Accounting methods.* In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method(s) it uses for tax purposes as an S corporation.

(e) *Example.* The rules of this section are illustrated by the following example.

Example: Net recognized built-in gain. X is a calendar year C corporation that elects to become an S corporation on January 1, 1996. X has a net unrealized built-in gain of \$50,000 and no net operating loss or capital loss carryforwards. In 1996, X has a pre-limitation amount of \$20,000, consisting of ordinary income of \$15,000 and capital gain of \$5,000, a taxable income limitation of \$9,600, and a net unrealized built-in gain limitation of \$50,000. Therefore, X's net recognized built-in gain for 1996 is \$9,600, because that is the least of the three amounts described in paragraph (a) of this section. Under paragraph (b) of this section, X's net recognized built-in gain consists of recognized built-in ordinary income of \$7,200 [$\$15,000 \times (\$9,600 / \$20,000) = \$7,200$] and recognized built-in capital gain of \$2,400 [$\$5,000 \times (\$9,600 / \$20,000) = \$2,400$]. Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of \$10,400 ($\$20,000 - \$9,600 = \$10,400$), consisting of \$7,800 ($\$15,000 - \$7,200 = \$7,800$) of recognized built-in ordinary income and \$2,600 ($\$5,000 - \$2,400 = \$2,600$) of recognized built-in capital gain.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374-3 Net unrealized built-in gain.

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in para-

graph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Example.* The rules of this section are illustrated by the following example.

Example: 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—	(100,000)
Basis of X's assets—	(900,000)
Section 481 adjustments	60,000
Net unrealized built-in gain—	110,000

[T.D. 8579, 59 FR 66464, Dec. 27, 1994]

§ 1.1374-4 Recognized built-in gain or loss.

(a) *Sales and exchanges—(1) In general.* Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during

the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property.* For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

(3) *Examples.* The rules of this paragraph (a) are illustrated by the following examples.

Example 1. Production and sale of oil. X is a C corporation that purchased a working interest in an oil and gas property for \$100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of \$250,000 and an adjusted basis of \$50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for \$75,000, and includes that amount in gross income. Under paragraph (a)(1) of this section, the \$75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

Example 2. Sale of oil and gas property. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own 50 percent of Y's stock. In addition, Y owns a royalty interest in an oil and gas property with a fair market value of \$300,000 and an adjusted basis of \$200,000. Under section 613A(c)(11)(B), Y's \$200,000 adjusted basis in the royalty interest is allocated \$100,000 to A and \$100,000 to B. During 1996, A and B take depletion deductions with respect to the royalty interest of \$10,000 and \$15,000, respectively. As of January 1, 1997, A and B have a basis in the royalty interest of \$90,000 and \$85,000, respectively. On January 1, 1997, Y sells the royalty interest for \$250,000. Under paragraph (a)(1) of this section, Y has gain recognized and recognized built-in gain of \$75,000 ($\$250,000 - (\$90,000 + \$85,000) = \$75,000$) on the sale.

(b) *Accrual method rule—(1) Income items.* Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer

must be made unless the taxpayer actually used the method when it was a C corporation).

(2) *Deduction items.* Except as otherwise provided in this section, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation). In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

(3) *Examples.* The rules of this paragraph (b) are illustrated by the following examples.

Example 1. Accounts receivable. X is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. On January 1, 1996, X has \$50,000 of accounts receivable for services rendered before that date. On that date, the accounts receivable have a fair market value of \$40,000 and an adjusted basis of \$0. In 1996, X collects \$50,000 on the accounts receivable and includes that amount in gross income. Under paragraph (b)(1) of this section, the \$50,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period if X had been an accrual method taxpayer. However, if X instead disposes of the accounts receivable for \$45,000 on July 1, 1996, in a transaction treated as a sale or exchange for Federal income tax purposes, X would have recognized built-in gain of \$40,000 on the disposition.

Example 2. Contingent liability. Y is a C corporation using the cash method that elects to become an S corporation effective January 1, 1996. In 1995, a lawsuit was filed against Y claiming \$1,000,000 in damages. In 1996, Y loses the lawsuit, pays a \$500,000 judgment, and properly claims a deduction for that amount. Under paragraph (b)(2) of this section, the \$500,000 deduction allowed in 1996

is not recognized built-in loss because it would not have been allowed as a deduction against gross income before the beginning of the recognition period if Y had been an accrual method taxpayer (even disregarding section 461(h)(2)(C) and § 1.461-4(g)).

Example 3. Deferred payment liabilities. X is a C corporation using the cash method that elects to become an S corporation on January 1, 1996. In 1995, X lost a lawsuit and became obligated to pay \$150,000 in damages. Under section 461(h)(2)(C), this amount is not allowed as a deduction until X makes payment. In 1996, X makes payment and properly claims a deduction for the amount of the payment. Under paragraph (b)(2) of this section, the \$150,000 deduction allowed in 1996 is recognized built-in loss because it would have been allowed as a deduction against gross income before the beginning of the recognition period if X had been an accrual method taxpayer (disregarding section 461(h)(2)(C) and § 1.461-4(g)).

Example 4. Deferred prepayment income. Y is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, Y received \$2,500 for services to be rendered in 1996, and properly elected to include the \$2,500 in gross income in 1996 under Rev. Proc. 71-21, 1971-2 C.B. 549 (see § 601.601(d)(2)(ii)(b) of this chapter). Under paragraph (b)(1) of this section, the \$2,500 included in gross income in 1996 is not recognized built-in gain because it would not have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that Y actually used before the beginning of the recognition period.

Example 5. Change in method. X is a C corporation using an accrual method that elects to become an S corporation effective January 1, 1996. In 1995, X received \$5,000 for services to be rendered in 1996, and properly included the \$5,000 in gross income. In 1996, X properly elects to include the \$5,000 in gross income in 1996 under Rev. Proc. 71-21, 1971-2 C.B. 549 (see § 601.601(d)(2)(ii)(b) of this chapter). As a result of the change in method of accounting, X has a \$5,000 negative section 481(a) adjustment. Under paragraph (b)(1) of this section, the \$5,000 included in gross income in 1996 is recognized built-in gain because it would have been included in gross income before the beginning of the recognition period by an accrual method taxpayer using the method that X actually used before the beginning of the recognition period. In addition, the \$5,000 negative section 481(a) adjustment is recognized built-in loss because it relates to an item (the \$5,000 X received for services in 1995) attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. See paragraph (d) of this section for rules regarding section 481(a) adjustments.

(c) *Section 267(a)(2) and 404(a)(5) deductions*—(1) *Section 267(a)(2)*. Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is paid—

(A) In the first two and one-half months of the recognition period; or

(B) To a related party owning, under the attribution rules of section 267, less than 5 percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

(2) *Section 404(a)(5)*. Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 404(a)(5), relating to payments for deferred compensation, is recognized built-in loss to the extent—

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is not paid to a related party to which section 267(a)(2) applies.

(3) *Examples.* The rules of this paragraph (c) are illustrated by the following examples.

Example 1. Fixed annuity. X is a C corporation that elects to become an S corporation effective January 1, 1996. On December 31, 1995, A is age 60, has provided services to X as an employee for 20 years, and is a vested participant in X's unfunded nonqualified retirement plan. Under the plan, A receives \$1,000 per month upon retirement until death. The plan provides no additional benefits. A retires on December 31, 1997, after working for X for 22 years. A at no time is a shareholder of X. X's deductions under section 404(a)(5) in the recognition period on paying A the \$1,000 per month are recognized built-in loss because all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period.

Example 2. Increase in annuity for working beyond 20 years. The facts are the same as *Example 1*, except that under the plan A receives \$1,000 per month, plus \$100 per month for each year A works for X beyond 20 years, upon retirement until death. X's deductions on paying A the \$1,000 per month are recognized built-in loss. However, X's deductions on paying A the \$200 per month for the two years A worked for X beyond 20 years are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

Example 3. Cost of living adjustment. The facts are the same as *Example 1*, except that under the plan A receives \$1,000 per month, plus annual cost of living adjustments, upon retirement until death. X's deductions under section 404(a)(5) on paying A the \$1,000 per month are recognized built-in loss. However, X's deductions under section 404(a)(5) on paying A the annual cost of living adjustment are not recognized built-in loss because all events have not occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability cannot be determined, as of the beginning of the recognition period.

(d) *Section 481(a) adjustments—(1) In general.* Any section 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section. The principles for determining recognized built-in gain or loss in this section include, for example, the accrual method rule under paragraph (b) of this section.

(2) *Examples.* The rules of this paragraph (d) are illustrated by the following examples.

Example 1. Omitted item attributable to preresognition period. X is a C corporation that elects to become an S corporation effective January 1, 1996. X improperly capitalizes repair costs and recovers the costs through depreciation of the related assets. In 1999, X properly changes to deducting repair costs as they are incurred. Under section 481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. In addition, X has a negative section 481(a) adjustment equal to the basis reduction. Under para-

graph (d)(1) of this section, the portion of X's negative section 481(a) adjustment relating to the repair costs incurred before the recognition period is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

Example 2. Duplicated item attributable to preresognition period. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y improperly uses an accrual method without regard to the economic performance rules of section 461(h) to account for worker's compensation claims. As a result, Y takes deductions when claims are filed. In 1999, Y properly changes to an accrual method with regard to the economic performance rules under section 461(h)(2)(C) for worker's compensation claims. As a result, Y takes deductions when claims are paid. The positive section 481(a) adjustment resulting from the change is equal to the amount of claims filed, but unpaid, before the year of change. Under paragraph (b)(2) of this section, the deduction allowed in the recognition period for claims filed, but unpaid, before the recognition period is recognized built-in loss because a deduction was allowed for those claims before the recognition period under an accrual method without regard to section 461(h)(2)(C). Under paragraph (d)(1) of this section, the portion of Y's positive section 481(a) adjustment relating to claims filed, but unpaid, before the recognition period is recognized built-in gain because those claims are items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this section.

(e) *Section 995(b)(2) deemed distributions.* Any item of income properly taken into account during the recognition period under section 995(b)(2) is recognized built-in gain if the item results from a DISC termination or disqualification occurring before the beginning of the recognition period.

(f) *Discharge of indebtedness and bad debts.* Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under section 61(a)(12) or as a bad debt deduction under section 166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.

(g) *Completion of contract.* Any item of income properly taken into account

during the recognition period under the completed contract method (as described in §1.451-3(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method (as described in §1.451-3(c)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.

(h) *Installment method*—(1) *In general.* If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under section 453 during or after the recognition period, that income is subject to tax under section 1374.

(2) *Limitation on amount subject to tax.* For purposes of paragraph (h)(1) of this section, the taxable income limitation under §1.1374-2(a)(2) is equal to the amount by which the S corporation's net recognized built-in gain would have been increased from the year of the sale to the earlier of the year the income is reported under the installment method or the last year of the recognition period, assuming all income from the sale had been reported in the year of the sale and all provisions of section 1374 applied. For purposes of the preceding sentence, if the corporation sells the asset before the recognition period, the income from the sale that is not reported before the recognition period is treated as having been reported in the first year of the recognition period.

(3) *Rollover rule.* If the limitation in paragraph (h)(2) of this section applies, the excess of the amount reported under the installment method over the amount subject to tax under the limitation is treated as if it were reported in the succeeding taxable year(s), but only for succeeding taxable year(s) in the recognition period. The amount reported in the succeeding taxable year(s) under the preceding sentence is reduced to the extent that the amount not subject to tax under the limitation

in paragraph (h)(2) of this section was not subject to tax because the S corporation had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

(4) *Use of losses and section 1374 attributes.* If income is reported under the installment method by an S corporation for a taxable year after the recognition period and the income is subject to tax under paragraph (h)(1) of this section, the S corporation's section 1374 attributes may be used to the extent their use is allowed under all applicable provisions of the Code in determining the section 1374 tax. However, the S corporation's loss recognized for a taxable year after the recognition period that would have been recognized built-in loss if it had been recognized in the recognition period may not be used in determining the section 1374 tax.

(5) *Examples.* The rules of this paragraph (h) are illustrated by the following examples.

Example 1. Rollover rule. X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X sells Blackacre with a basis of \$0 and a value of \$100,000 in exchange for a \$100,000 note bearing a market rate of interest payable on January 1, 2001. X does not make the election under section 453(d) and, therefore, reports the \$100,000 gain using the installment method under section 453. In the year 2001, X has income of \$100,000 on collecting the note, unexpired C year attributes of \$0, recognized built-in loss of \$0, current losses of \$100,000, and taxable income of \$0. If X had reported the \$100,000 gain in 1996, X's net recognized built-in gain from 1996 through 2001 would have been \$75,000 greater than otherwise. Under paragraph (h) of this section, X has \$75,000 net recognized built-in gain subject to tax under section 1374. X also must treat the \$25,000 excess of the amount reported, \$100,000, over the amount subject to tax, \$75,000, as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent X establishes that the \$25,000 was not subject to tax under section 1374 in the year 2001 because X had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period.

Example 2. Use of losses. Y is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Y

sells Whiteacre with a basis of \$0 and a value of \$250,000 in exchange for a \$250,000 note bearing a market rate of interest payable on January 1, 2006. Y does not make the election under section 453(d) and, therefore, reports the \$250,000 gain using the installment method under section 453. In the year 2006, Y has income of \$250,000 on collecting the note, unexpired C year attributes of \$0, loss of \$100,000 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of \$150,000, and taxable income of \$0. If Y had reported the \$250,000 gain in 1996, X's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been \$225,000 greater than otherwise. Under paragraph (h) of this section, X has \$225,000 net recognized built-in gain subject to tax under section 1374.

Example 3. Use of section 1374 attribute. Z is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, Z sells Greenacre with a basis of \$0 and a value of \$500,000 in exchange for a \$500,000 note bearing a market rate of interest payable on January 1, 2011. Z does not make the election under section 453(d) and, therefore, reports the \$500,000 gain using the installment method under section 453. In the year 2011, Z has income of \$500,000 on collecting the note, loss of \$0 that would have been recognized built-in loss if it had been recognized in the recognition period, current losses of \$0, taxable income of \$500,000, and a minimum tax credit of \$60,000 arising in 1995. None of Z's minimum tax credit is limited under sections 53(c) or 383. If Z had reported the \$500,000 gain in 1996, Z's net recognized built-in gain from 1996 through 2005 (that is, during the recognition period) would have been \$350,000 greater than otherwise. Under paragraph (h) of this section, Z has \$350,000 net recognized built-in gain subject to tax under section 1374, a tentative section 1374 tax of \$122,500 ($\$350,000 \times .35 = \$122,500$), and a section 1374 tax after using its minimum tax credit arising in 1995 of \$62,250 ($\$122,500 - \$60,000 = \$62,250$).

(i) *Partnership interests—(1) In general.* If an S corporation owns a partnership interest at the beginning of the recognition period or transfers property to a partnership in a transaction to which section 1374(d)(6) applies during the recognition period, the S corporation determines the effect on net recognized built-in gain from its distributive share of partnership items as follows—

(i) Step One: Apply the rules of section 1374(d) to the S corporation's distributive share of partnership items of income, gain, loss, or deduction included in income or allowed as a deduc-

tion under the rules of subchapter K to determine the extent to which it would have been treated as recognized built-in gain or loss if the partnership items had originated in and been taken into account directly by the S corporation (partnership 1374 items);

(ii) Step Two: Determine the S corporation's net recognized built-in gain without partnership 1374 items;

(iii) Step Three: Determine the S corporation's net recognized built-in gain with partnership 1374 items; and

(iv) Step Four: If the amount computed under Step Three (paragraph (i)(1)(iii) of this section) exceeds the amount computed under Step Two (paragraph (i)(1)(ii) of this section), the excess (as limited by paragraph (i)(2)(i) of this section) is the S corporation's partnership RBIG, and the S corporation's net recognized built-in gain is the sum of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) plus the partnership RBIG. If the amount computed under Step Two (paragraph (i)(1)(ii) of this section) exceeds the amount computed under Step Three (paragraph (i)(1)(iii) of this section), the excess (as limited by paragraph (i)(2)(ii) of this section) is the S corporation's partnership RBIL, and the S corporation's net recognized built-in gain is the remainder of the amount computed under Step Two (paragraph (i)(1)(ii) of this section) after subtracting the partnership RBIL.

(2) *Limitations—(i) Partnership RBIG.* An S corporation's partnership RBIG for any taxable year may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG for prior taxable years. The preceding sentence does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(ii) *Partnership RBIL.* An S corporation's partnership RBIL for any taxable year may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL for prior taxable years.

(3) *Disposition of partnership interest.* If an S corporation disposes of its partnership interest, the amount that may be treated as recognized built-in gain

may not exceed the excess (if any) of the S corporation's RBIG limitation over its partnership RBIG during the recognition period. Similarly, the amount that may be treated as recognized built-in loss may not exceed the excess (if any) of the S corporation's RBIL limitation over its partnership RBIL during the recognition period.

(4) *RBIG and RBIL limitations*—(i) *Sale of partnership interest*. An S corporation's RBIG or RBIL limitation is the total of the following—

(A) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold its partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at fair market value to an unrelated party; decreased by

(B) The corporation's adjusted basis in the partnership interest (and any assets the corporation contributed to the partnership during the recognition period) at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section; and increased or decreased by

(C) The corporation's allocable share of the partnership's section 481(a) adjustments at the time of the sale referred to in paragraph (i)(4)(i)(A) of this section.

(ii) *Amounts of limitations*. If the result in paragraph (i)(4)(i) of this section is a positive amount, the S corporation has a RBIG limitation equal to that amount and a RBIL limitation of \$0, but if the result in paragraph (i)(4)(i) of this section is a negative amount, the S corporation has a RBIL limitation equal to that amount and a RBIG limitation of \$0.

(5) *Small interest exception*—(i) *In general*. Paragraph (i)(1) of this section does not apply to a taxable year in the recognition period if the S corporation's partnership interest represents less than 10 percent of the partnership's capital and profits at all times during the taxable year and prior taxable years in the recognition period, and the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is less than \$100,000.

(ii) *Contributed assets*. For purposes of paragraph (i)(5)(i) of this section, if the S corporation contributes any assets to the partnership during the recognition period and the S corporation held the assets as of the beginning of the recognition period, the fair market value of the S corporation's partnership interest as of the beginning of the recognition period is determined as if the assets were contributed to the partnership before the beginning of the recognition period (using the fair market value of each contributed asset as of the beginning of the recognition period). The contribution does not affect whether paragraph (i)(5)(i) of this section applies for taxable years in the recognition period before the taxable year in which the contribution was made.

(iii) *Anti-abuse rule*. Paragraph (i)(5)(i) of this section does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374.

(6) *Section 704(c) gain or loss*. Solely for purposes of section 1374, an S corporation's section 704(c) gain or loss amount with respect to any asset is not reduced during the recognition period, except for amounts treated as recognized built-in gain or loss with respect to that asset under this paragraph.

(7) *Disposition of distributed partnership asset*. If on the first day of the recognition period an S corporation holds an interest in a partnership that holds an asset and during the recognition period the partnership distributes the asset to the S corporation that thereafter disposes of the asset, the asset is treated as having been held by the S corporation on the first day of the recognition period and as having the fair market value and adjusted basis in the hands of the S corporation that it had in the hands of the partnership on that day.

(8) *Examples*. The rules of this paragraph (i) are illustrated by the following examples.

Example 1. Pre-conversion partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P and P owns (among other assets) Blackacre with a basis of \$25,000 and a

value of \$45,000. In 1996, P buys Whiteacre for \$50,000. In 1999, P sells Blackacre for \$55,000 and recognizes a gain of \$30,000 of which \$15,000 is included in X's distributive share. P also sells Whiteacre in 1999 for \$42,000 and recognizes a loss of \$8,000 of which \$4,000 is included in X's distributive share. Under this paragraph and section 1374(d)(3), X's \$15,000 gain is presumed to be recognized built-in gain and thus treated as a partnership 1374 item, but this presumption is rebutted if X establishes that P's gain would have been only \$20,000 ($\$45,000 - \$25,000 = \$20,000$) if Blackacre had been sold on the first day of the recognition period. In such a case, only X's distributive share of the \$20,000 built-in gain, \$10,000, would be treated as a partnership 1374 item. Under this paragraph and section 1374(d)(4), X's \$4,000 loss is not treated as a partnership 1374 item because P did not hold Whiteacre on the first day of the recognition period.

Example 2. Post-conversion contribution. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns (among other assets) Blackacre with a basis of \$100,000 and a value of \$200,000. On January 1, 1998, when Blackacre has a basis of \$100,000 and a value of \$200,000, Y contributes Blackacre to partnership P for a 50 percent interest in P. On January 1, 2000, P sells Blackacre for \$300,000 and recognizes a gain of \$200,000 on the sale ($\$300,000 - \$100,000 = \$200,000$). P is allocated \$100,000 of the gain under section 704(c), and another \$50,000 of the gain for its fifty percent share of the remainder, for a total of \$150,000. Under this paragraph and section 1374(d)(3), if Y establishes that P's gain would have been only \$100,000 ($\$200,000 - \$100,000 = \$100,000$) if Blackacre had been sold on the first day of the recognition period, Y would treat only \$100,000 as a partnership 1374 item.

Example 3. RBIG limitation of \$100,000 or \$50,000. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of \$100,000 and a RBIL limitation of \$0. P owns (among other assets) Blackacre with a basis of \$50,000 and a value of \$200,000. In 1996, P sells Blackacre for \$200,000 and recognizes a gain of \$150,000 of which \$75,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is \$35,000 and with partnership 1374 items is \$110,000. Thus, X has a partnership RBIG of \$75,000 except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is \$100,000, X's partnership RBIG of \$75,000 is not limited and X's net recognized built-in gain for the year is \$110,000 ($\$35,000 + \$75,000 = \$110,000$). However, if X had a RBIG limitation of \$50,000 instead of \$100,000, X's partnership RBIG would be limited to \$50,000 under paragraph (i)(2)(i) of this section and X's net recognized built-in gain would be \$85,000 ($\$35,000 + \$50,000 = \$85,000$).

ited to \$50,000 under paragraph (i)(2)(i) of this section and X's net recognized built-in gain would be \$85,000 ($\$35,000 + \$50,000 = \$85,000$).

Example 4. RBIL limitation of \$60,000 or \$40,000. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y owns a 50 percent interest in partnership P with a RBIG limitation of \$0 and a RBIL limitation of \$60,000. P owns (among other assets) Blackacre with a basis of \$225,000 and a value of \$125,000. In 1996, P sells Blackacre for \$125,000 and recognizes a loss of \$100,000 of which \$50,000 is included in Y's distributive share and treated as a partnership 1374 item. Y's net recognized built-in gain for 1996 computed without partnership 1374 items is \$75,000 and with partnership 1374 items is \$25,000. Thus, Y has a partnership RBIL of \$50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is \$60,000, Y's partnership RBIL for the year is not limited and Y's net recognized built-in gain for the year is \$25,000 ($\$75,000 - \$50,000 = \$25,000$). However, if Y had a RBIL limitation of \$40,000 instead of \$60,000, Y's partnership RBIL would be limited to \$40,000 under paragraph (i)(2)(ii) of this section and Y's net recognized built-in gain for the year would be \$35,000 ($\$75,000 - \$40,000 = \$35,000$).

Example 5. RBIG limitation of \$0. (i) X is a C corporation that elects to become an S corporation on January 1, 1996. X owns a 50 percent interest in partnership P with a RBIG limitation of \$0 and a RBIL limitation of \$25,000.

- (a) In 1996, P's partnership 1374 items are—
- (1) Ordinary income of \$25,000; and
 - (2) Capital gain of \$75,000.
- (b) X itself has—
- (1) Recognized built-in ordinary income of \$40,000; and
 - (2) Recognized built-in capital loss of \$90,000.

(ii) X's net recognized built-in gain for 1996 computed without partnership 1374 items is \$40,000 and with partnership 1374 items is \$65,000 ($\$40,000 + \$25,000 = \$65,000$). Thus, X's partnership RBIG is \$25,000 for the year except as limited under paragraph (i)(2)(i) of this section. Because X's RBIG limitation is \$0, X's partnership RBIG of \$25,000 is limited to \$0 and X's net recognized built-in gain for the year is \$40,000.

Example 6. RBIL limitation of \$0. (i) Y is a C corporation that elects to become an S corporation on January 1, 1996. Y owns a 50 percent interest in partnership P with a RBIG limitation of \$60,000 and a RBIL limitation of \$0.

- (a) In 1996, P's partnership 1374 items are—
- (1) Ordinary income of \$25,000; and
 - (2) Capital loss of \$90,000.
- (b) Y itself has—
- (1) recognized built-in ordinary income of \$40,000; and

(2) recognized built-in capital gain of \$75,000.

(ii) Y's net recognized built-in gain for 1996 computed without partnership 1374 items is \$115,000 ($\$40,000 + \$75,000 = \$115,000$) and with partnership 1374 items is \$65,000 ($\$40,000 + \$25,000 = \$65,000$). Thus, Y's partnership RBIL is \$50,000 for the year except as limited under paragraph (i)(2)(ii) of this section. Because Y's RBIL limitation is \$0, Y's partnership RBIL of \$50,000 is limited to \$0 and Y's net recognized built-in gain is \$115,000.

Example 7. Disposition of partnership interest. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a 50 percent interest in partnership P with a RBIG limitation of \$200,000 and a RBIL limitation of \$0. P owns (among other assets) Blackacre with a basis of \$20,000 and a value of \$140,000. In 1996, P sells Blackacre for \$140,000 and recognizes a gain of \$120,000 of which \$60,000 is included in X's distributive share and treated as a partnership 1374 item. X's net recognized built-in gain for 1996 computed without partnership 1374 items is \$95,000 and with partnership 1374 items is \$155,000. Thus, X has a partnership RBIG of \$60,000. In 1999, X sells its entire interest in P for \$350,000 and recognizes a gain of \$250,000. Under paragraph (i)(3) of this section, X's recognized built-in gain on the sale is limited by its RBIG limitation to \$140,000 ($\$200,000 - \$60,000 = \$140,000$).

Example 8. Section 704(c) case. Y is a C corporation that elects to become an S corporation on January 1, 1996. On that date, Y contributes Asset 1, 5-year property with a value of \$40,000 and a basis of \$0, and an unrelated party contributes \$40,000 in cash, each for a 50 percent interest in partnership P. The partnership adopts the traditional method under § 1.704-3(b). If P sold Asset 1 for \$40,000 immediately after it was contributed by Y, P's \$40,000 gain would be allocated to Y under section 704(c). Instead, Asset 1 is sold by P in 1999 for \$36,000 and P recognizes gain of \$36,000 ($\$36,000 - \$0 = \$36,000$) on the sale. However, because book depreciation of \$8,000 per year has been taken on Asset 1 in 1996, 1997, and 1998, Y is allocated only \$16,000 of P's \$36,000 gain ($\$40,000 - (3 \times \$8,000) = (\$16,000 - \$0) = \$16,000$) under section 704(c). The remaining \$20,000 of P's \$36,000 gain ($\$36,000 - \$16,000 = \$20,000$) is allocated 50 percent to each partner under section 704(b). Thus, a total of \$26,000 ($\$16,000 + \$10,000 = \$26,000$) of P's \$36,000 gain is allocated to Y. However, under paragraph (i)(6) of this section, Y treats \$36,000 as a partnership 1374 item on P's sale of Asset 1.

Example 9. Disposition of distributed partnership asset. X is a C corporation that elects to become an S corporation on January 1, 1996. On that date, X owns a fifty percent interest in partnership P and P owns (among other assets) Blackacre with a basis of \$20,000 and

a value of \$40,000. On January 1, 1998, P distributes Blackacre to X, when Blackacre has a basis of \$20,000 and a value of \$50,000. Under section 732(a)(1), X has a transferred basis of \$20,000 in Blackacre. On January 1, 1999, X sells Blackacre for \$60,000 and recognizes a gain of \$40,000. Under paragraph (i)(7) of this section and section 1374(d)(3), X has recognized built-in gain from the sale of \$20,000, the amount of built-in gain in Blackacre on the first day of the recognition period.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994]

§ 1.1374-5 Loss carryforwards.

(a) *In general.* The loss carryforwards allowed as deductions against net recognized built-in gain under section 1374(b)(2) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other loss carryforwards, such as charitable contribution carryforwards under section 170(d)(2), are not allowed as deductions against net recognized built-in gain.

(b) *Example.* The rules of this section are illustrated by the following example.

Example: Section 382 limitation. X is a C corporation that has an ownership change under section 382(g)(1) on January 1, 1994. On that date, X has a fair market value of \$500,000, NOL carryforwards of \$400,000, and a net unrealized built-in gain under section 382(h)(3)(A) of \$0. Assume X's section 382 limitation under section 382(b)(1) is \$40,000. X elects to become an S corporation on January 1, 1998. On that date, X has NOL carryforwards of \$240,000 (having used \$160,000 of its pre-change net operating losses in its 4 preceding taxable years) and a section 1374 net unrealized built-in gain of \$250,000. In 1998, X has net recognized built-in gain of \$100,000. X may use \$40,000 of its NOL carryforwards as a deduction against its \$100,000 net recognized built-in gain, because X's section 382 limitation is \$40,000.

[T.D. 8579, 59 FR 66469, Dec. 27, 1994]

§ 1.1374-6 Credits and credit carryforwards.

(a) *In general.* The credits and credit carryforwards allowed as credits against the section 1374 tax under section 1374(b)(3) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other credits or credit carryforwards, such as foreign tax credits under section 901, are not allowed as credits against the section 1374 tax.