

faith and using due diligence determined that it had no subchapter C earnings and profits at the close of the taxable year, a description of how and on what date it was determined that the S corporation had subchapter C earnings and profits at the close of the year and a description (including dates) of any steps taken to distribute such earnings and profits. If the earnings and profits have not yet been distributed, the request shall contain a timetable for distribution and an explanation of why such timetable is reasonable. On the date the waiver is to become effective, all subchapter C earnings and profits must have been distributed.

(e) *Reduction in pass-thru for tax imposed on excess net passive income.* See section 1366(f)(3) for a special rule reducing each item of the corporation's passive investment income for purposes of section 1366(a) if a tax is imposed on the corporation under section 1375.

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

Example 1. Assume Corporation M, an S corporation, has for its taxable year total gross receipts of \$200,000, passive investment income of \$100,000, \$60,000 of which is interest income, and expenses directly connected with the production of such interest income in the amount of \$10,000. Assume also that at the end of the taxable year Corporation M has subchapter C earnings and profits. Since more than 25 percent of the Corporation M's total gross receipts are passive investment income, and since Corporation M has subchapter C earnings and profits at the end of the taxable year, Corporation M will be subject to the tax imposed by section 1375. The amount of excess net passive investment income is \$45,000 ($\$90,000 \times (50,000 / 100,000)$). Assume that the other \$40,000 of passive investment income is attributable to net capital gain and that there are no expenses directly connected with such gain. Under these facts, \$20,000 of the excess net passive income is attributable to the net capital gain ($\$45,000 \times (\$40,000 / \$90,000)$). Accordingly, the amount of gain taken into account under section 1374(b)(1) and the taxable income of Corporation M under section 1374(b)(2) shall be reduced by \$20,000.

Example 2. Assume an S corporation with subchapter C earnings and profits has tax-exempt income of \$400, its only passive income, gross receipts of \$1,000 and taxable income of \$250 and there are no expenses associated with the tax-exempt income. The corporation's excess net income for the taxable year would total \$150 ($400 \times ((400 - 250) / 400)$). This

amount is subject to the tax imposed by section 1375, notwithstanding that such amount is otherwise tax-exempt income.

[T.D. 8104, 51 FR 34203, Sept. 26, 1986; 52 FR 9162, Mar. 23, 1987. Redesignated and amended by T.D. 8419, 57 FR 22653, May 29, 1992]

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[T.D. 8696, 61 FR 67455, Dec. 23, 1996, as amended by T.D. 8994, 67 FR 34401, May 14, 2002]

§ 1.1377-1 Pro rata share.

(a) *Computation of pro rata shares—(1) In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue