

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 described 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 nonrecognition 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) *LIFO inventory held indirectly through partnership.* A C corporation must include the lookthrough LIFO recapture amount (as defined in paragraph (c)(4) of this section) in its gross income—

(1) In its last taxable year as a C corporation if, on the last day of the corporation's last taxable year before its S corporation election becomes effective, the corporation held a lookthrough partnership interest (as defined in paragraph (c)(3) of this section); or

(2) In the year of transfer by the C corporation to an S corporation of a lookthrough partnership interest if the corporation transferred its lookthrough partnership interest to the S corporation in a nonrecognition transaction (within the meaning of section 7701(a)(45)) in which the transferred interest constitutes transferred basis property (within the meaning of section 7701(a)(43)).

(c) *Definitions and special rules—*(1) *Recapture date.* In the case of a transaction described in paragraph (a)(1) or (b)(1) of this section, the recapture date is the day before the effective date of the S corporation election. In the case of a transaction described in paragraph (a)(2) or (b)(2) of this section, the recapture date is the date of the transfer of the partnership interest to the S corporation.

(2) *Determination of LIFO recapture amount.* The LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (a)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (a)(2) of this section.

(3) *Lookthrough partnership interest.* A partnership interest is a lookthrough

partnership interest if the partnership owns (directly or indirectly through one or more partnerships) assets accounted for under the last-in, first-out (LIFO) method (LIFO inventory).

(4) *Lookthrough LIFO recapture amount*—(i) *In general.* For purposes of this section, a corporation's lookthrough LIFO recapture amount is the amount of income that would be allocated to the corporation, taking into account section 704(c) and § 1.704-3, if the partnership sold all of its LIFO inventory for the inventory's FIFO value. For this purpose, the FIFO value of inventory is the inventory amount of the inventory assets under the first-in, first-out method of accounting authorized by section 471, determined in accordance with section 1363(d)(4)(C).

(ii) *Determination of lookthrough LIFO recapture amount.* Except as provided in paragraph (c)(4)(iii) of this section, the lookthrough LIFO recapture amount shall be determined as of the end of the recapture date for transactions described in paragraph (b)(1) of this section, and as of the moment before the transfer occurs for transactions described in paragraph (b)(2) of this section.

(iii) *Alternative rule.* If the partnership is not otherwise required to determine the inventory amount of the inventory using the LIFO method (the LIFO value) on the recapture date, the partnership may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year that includes the recapture date. For this purpose, the opening inventory includes inventory contributed by a partner to the partnership on or before the recapture date and excludes inventory distributed by the partnership to a partner on or before the recapture date. A partnership that applies the alternative method of this paragraph (c)(4)(iii) to calculate the lookthrough LIFO recapture amount must take into account any adjustments to the partnership's basis in its LIFO inventory that result from transactions occurring after the start of the partnership's taxable year and before the end of the recapture date.

For example, the lookthrough LIFO recapture amount must be adjusted to take into account any adjustments to the basis of LIFO inventory during that period under sections 734(b), 737(c), or 751(b).

(d) *Payment of tax.* Any increase in tax caused by including the LIFO recapture amount or the lookthrough LIFO recapture amount in the gross income of the C corporation is payable in four equal installments. The C corporation must pay the first installment of this payment by the due date of its return, determined without regard to extensions, for the last taxable year it operated as a C corporation if paragraph (a)(1) or (b)(1) of this section applies, or for the taxable year of the transfer if paragraph (a)(2) or (b)(2) of this section applies. The three succeeding installments must be paid—

(1) For a transaction described in paragraph (a)(1) or (b)(1) of this section, by the corporation that made the election under section 1362(a) to be an S corporation, on or before the due date for the corporation's returns (determined without regard to extensions) for the succeeding three taxable years; and

(2) For a transaction described in paragraph (a)(2) or (b)(2) of this section, by the transferee S corporation on or before the due date for the transferee corporation's returns (determined without regard to extensions) for the succeeding three taxable years.

(e) *Basis adjustments*—(1) *General rule.* Appropriate adjustments to the basis of inventory are to be made to reflect any amount included in income under paragraph (a) of this section.

(2) *LIFO inventory owned through a partnership*—(i) *Basis of corporation's partnership interest.* Appropriate adjustments to the basis of the corporation's lookthrough partnership interest are to be made to reflect any amount included in income under paragraph (b) of this section.

(ii) *Basis of partnership assets.* A partnership directly holding LIFO inventory that is taken into account under paragraph (b) of this section may elect to adjust the basis of that LIFO inventory. In addition, a partnership that holds, through another partnership,

LIFO inventory that is taken into account under paragraph (b) of this section may elect to adjust the basis of that partnership interest. Any adjustment under this paragraph (e)(2) to the basis of inventory held by the partnership is equal to the amount of LIFO recapture attributable to the inventory. Likewise, any adjustment under this paragraph (e)(2) to the basis of a lookthrough partnership interest held by the partnership is equal to the amount of LIFO recapture attributable to the interest. A basis adjustment under this paragraph (e)(2) is treated in the same manner and has the same effect as an adjustment to the basis of partnership property under section 743(b). See § 1.743-1(j).

(3) *Election.* A partnership elects to adjust the basis of its inventory and any lookthrough partnership interest that it owns by attaching a statement to its original or amended income tax return for the first taxable year ending on or after the date of the S corporation election or transfer described in paragraph (b) of this section. This statement shall state that the partnership is electing under this paragraph (e)(3) and must include the names, addresses, and taxpayer identification numbers of any corporate partner liable for tax under paragraph (d) of this section and of the partnership, as well as the amount of the adjustment and the portion of the adjustment that is attributable to each pool of inventory or lookthrough partnership interest that is held by the partnership.

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

Example 1. (i) G is a C corporation with a taxable year ending on June 30. GH is a partnership with a calendar year taxable year. G has a 20 percent interest in GH. The remaining 80 percent interest is owned by an individual. On April 25, 2005, G contributed inventory that is LIFO inventory to GH, increasing G's interest in the partnership to 50 percent. GH holds no other LIFO inventory, and there are no other adjustments to the partnership's basis in its LIFO inventory between January 1, 2005 and the end of the recapture date. G elects to be an S corporation effective July 1, 2005. The recapture date is June 30, 2005 under paragraph (c)(1) of this section. GH elects to use the LIFO method for the inventory and determines that the FIFO and LIFO values of the opening inventory for GH's 2005 taxable year, including the

inventory contributed by G, are \$200 and \$120, respectively.

(ii) Under paragraph (c)(4)(iii) of this section, GH is not required to determine the FIFO and LIFO values of the inventory on the recapture date. Instead, GH may determine the lookthrough LIFO recapture amount as though the FIFO and LIFO values of the inventory on the recapture date equaled the FIFO and LIFO values of the opening inventory for the partnership's taxable year (2005) that includes the recapture date. For this purpose, under paragraph (c)(4) of this section, the opening inventory includes the inventory contributed by G. The amount by which the FIFO value (\$200) exceeds the LIFO value (\$120) in GH's opening inventory is \$80. Thus, if GH sold all of its LIFO inventory for \$200, it would recognize \$80 of income. G's lookthrough LIFO recapture amount is \$80, the amount of income that would be allocated to G, taking into account section 704(c) and § 1.704-3, if GH sold all of its LIFO inventory for the FIFO value. Under paragraph (b)(1) of this section, G must include \$80 in income in its taxable year ending on June 30, 2005. Under paragraph (e)(2) of this section, G must increase its basis in its interest in GH by \$80. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, GH may elect to increase the basis (with respect to G only) of its LIFO inventory by \$80.

Example 2. (i) J is a C corporation with a calendar year taxable year. JK is a partnership with a calendar year taxable year. J has a 30 percent interest in the partnership. JK owns LIFO inventory that is not section 704(c) property. J elects to be an S corporation effective January 1, 2005. The recapture date is December 31, 2004 under paragraph (c)(1) of this section. JK determines that the FIFO and LIFO values of the inventory on December 31, 2004 are \$240 and \$140, respectively.

(ii) The amount by which the FIFO value (\$240) exceeds the LIFO value (\$140) on the recapture date is \$100. Thus, if JK sold all of its LIFO inventory for \$240, it would recognize \$100 of income. J's lookthrough LIFO recapture amount is \$30, the amount of income that would be allocated to J if JK sold all of its LIFO inventory for the FIFO value (30 percent of \$100). Under paragraph (b)(1) of this section, J must include \$30 in income in its taxable year ending on December 31, 2004. Under paragraph (e)(2) of this section, J must increase its basis in its interest in JK by \$30. Under paragraphs (e)(2) and (3) of this section, and in accordance with section 743(b) principles, JK may elect to increase the basis (with respect to J only) of its inventory by \$30.

(g) *Effective dates.* (1) The provisions of paragraph (a)(1) of this section apply to S elections made after December 17,

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1987. For an exception, see section 10227(b)(2) of the Revenue Act of 1987.

(2) The provisions of paragraph (a)(2) of this section apply to transfers made after August 18, 1993.

(3) The provisions of paragraphs (b), (c), (d), (e)(2), (e)(3), and (f) of this section apply to S elections and transfers made on or after August 13, 2004. The rules that apply to S elections and transfers made before August 13, 2004, are contained in §1.1363-2 as in effect prior to August 13, 2004 (see 26 CFR part 1 revised as of April 1, 2005).

[T.D. 8567, 59 FR 51106, Oct. 7, 1994, as amended by T.D. 9210, 70 FR 39921, July 12, 2005]

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§ 1.1366-5 Effective date.

[T.D. 8852, 64 FR 71644, Dec. 22, 1999, as amended by T.D. 9422, 73 FR 47530, Aug. 14, 2008]

§ 1.1366-1 Shareholder's share of items of an S corporation.

(a) *Determination of shareholder's tax liability*—(1) *In general.* An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate