

the amount of gross income of the corporation used in deriving the shareholder's pro rata share of S corporation taxable income or loss (including items described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section). For example, a shareholder is required to include the shareholder's pro rata share of S corporation gross income in computing the shareholder's gross income for the purposes of determining the necessity of filing a return (section 6012(a)) and the shareholder's gross income derived from farming (sections 175 and 6654(i)).

(2) *Gross income for substantial omission of items*—(i) *In general.* For purposes of determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a shareholder's gross income includes the shareholder's pro rata share of S corporation gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of S corporation gross income used in deriving the shareholder's pro rata share of any item of S corporation income, loss, deduction, or credit (as included or disclosed in the shareholder's return) is considered as an amount of gross income stated in the shareholder's return for purposes of section 6501(e).

(ii) *Example.* The following example illustrates the provisions of paragraph (c)(2)(i) of this section:

Example. Shareholder A, an individual, owns 25 percent of the stock of Corporation N, an S corporation that has \$10,000 gross income and \$2,000 taxable income. A reports only \$300 as A's pro rata share of N's taxable income. A should have reported \$500 as A's pro rata share of taxable income, derived from A's pro rata share, \$2,500, of N's gross income. Because A's return included only \$300 without a disclosure meeting the requirements of section 6501(e)(1)(A)(ii) describing the difference of \$200, A is regarded as having reported on the return only \$1,500 (\$300/\$500 of \$2,500) as gross income from N.

(d) *Shareholders holding stock subject to community property laws.* If a shareholder holds S corporation stock that is community property, then the shareholder's pro rata share of any item or items listed in paragraphs (a)(2), (3), and (4) of this section with respect to that stock is reported by the husband

and wife in accordance with community property rules.

(e) *Net operating loss deduction of shareholder of S corporation.* For purposes of determining a net operating loss deduction under section 172, a shareholder of an S corporation must take into account the shareholder's pro rata share of items of income, loss, deduction, or credit of the corporation. See section 1366(b) and paragraph (b) of this section for rules on determining the character of the items. In determining under section 172(d)(4) the non-business deductions allowable to a shareholder of an S corporation (arising from both corporation sources and any other sources), the shareholder separately takes into account the shareholder's pro rata share of the deductions of the corporation that are not attributable to a trade or business and combines this amount with the shareholder's nonbusiness deductions from any other sources. The shareholder also separately takes into account the shareholder's pro rata share of the gross income of the corporation not derived from a trade or business and combines this amount with the shareholder's nonbusiness income from all other sources. See section 172 and the regulations thereunder.

(f) *Cross-reference.* For rules relating to the consistent tax treatment of subchapter S items, see section 6037(c).

[T.D. 8852, 64 FR 71645, Dec. 22, 1999]

§ 1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) *In general*—(1) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under § 1.1366-1(a) (2), (3), and (4) for any taxable year of an S corporation cannot exceed the sum of—

(i) The adjusted basis of the shareholder's stock in the corporation (as determined under paragraph (a)(3)(i) of this section); and

(ii) The adjusted basis of any indebtedness of the corporation to the shareholder (as determined under paragraph (a)(3)(ii) of this section).

(2) *Carryover of disallowance.* A shareholder's aggregate amount of losses

and deductions for a taxable year in excess of the sum of the adjusted basis of the shareholder's stock in an S corporation and of any indebtedness of the S corporation to the shareholder is not allowed for the taxable year. However, any disallowed loss or deduction retains its character and is treated as incurred by the corporation in the corporation's first succeeding taxable year, and subsequent taxable years, with respect to the shareholder. For rules on determining the adjusted bases of stock of an S corporation and indebtedness of the corporation to the shareholder, see paragraphs (a)(3) (i) and (ii) of this section.

(3) *Basis limitation amount*—(i) *Stock portion*. A shareholder generally determines the adjusted basis of stock for purposes of paragraphs (a)(1)(i) and (2) of this section (limiting losses and deductions) by taking into account only increases in basis under section 1367(a)(1) for the taxable year and decreases in basis under section 1367(a)(2) (A), (D) and (E) (relating to distributions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) for the taxable year. In so determining this loss limitation amount, the shareholder disregards decreases in basis under section 1367(a)(2) (B) and (C) (for losses and deductions, including losses and deductions previously disallowed) for the taxable year. However, if the shareholder has in effect for the taxable year an election under § 1.1367-1(g) to decrease basis by items of loss and deduction prior to decreasing basis by noncapital, nondeductible expenses and certain oil and gas depletion deductions, the shareholder also disregards decreases in basis under section 1367(a)(2) (D) and (E). This basis limitation amount for stock is determined at the time prescribed under § 1.1367-1(d)(1) for adjustments to the basis of stock.

(ii) *Indebtedness portion*. A shareholder determines the shareholder's adjusted basis in indebtedness of the corporation for purposes of paragraphs (a)(1)(ii) and (2) of this section (limiting losses and deductions) without regard to any adjustment under section 1367(b)(2)(A) for the taxable year. This basis limitation amount for indebtedness is determined at the time pre-

scribed under § 1.1367-2(d)(1) for adjustments to the basis of indebtedness.

(4) *Limitation on losses and deductions allocated to each item*. If a shareholder's pro rata share of the aggregate amount of losses and deductions specified in § 1.1366-1(a)(2), (3), and (4) exceeds the sum of the adjusted basis of the shareholder's stock in the corporation (determined in accordance with paragraph (a)(3)(i) of this section) and the adjusted basis of any indebtedness of the corporation to the shareholder (determined in accordance with paragraph (a)(3)(ii) of this section), then the limitation on losses and deductions under section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to any loss or deduction is an amount that bears the same ratio to the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For this purpose, the total of losses and deductions for the taxable year is the sum of the shareholder's pro rata share of losses and deductions for the taxable year, and the losses and deductions disallowed and carried forward from prior years pursuant to section 1366(d)(2).

(5) *Nontransferability of losses and deductions*—(i) *In general*. Except as provided in paragraph (a)(5)(ii) of this section, any loss or deduction disallowed under paragraph (a)(1) of this section is personal to the shareholder and cannot in any manner be transferred to another person. If a shareholder transfers some but not all of the shareholder's stock in the corporation, the amount of any disallowed loss or deduction under this section is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of the shareholder's stock in the corporation, any disallowed loss or deduction is permanently disallowed.

(ii) *Exceptions for transfers of stock under section 1041(a)*. If a shareholder transfers stock of an S corporation after December 31, 2004, in a transfer described in section 1041(a), any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder under paragraph (a)(1) of this section shall be

treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of any loss or deduction with respect to the stock transferred shall be determined by prorating any losses or deductions disallowed under paragraph (a)(1) of this section for the year of the transfer between the transferor and the spouse or former spouse based on the stock ownership at the beginning of the following taxable year. If a transferor claims a deduction for losses in the taxable year of transfer, then under paragraph (a)(4) of this section, if the transferor's pro rata share of the losses and deductions in the year of transfer exceeds the transferor's basis in stock and the indebtedness of the corporation to the transferor, then the limitation must be allocated among the transferor spouse's pro rata share of each loss or deduction, including disallowed losses and deductions carried over from the prior year.

(iii) *Examples.* The following examples illustrate the provisions of paragraph (a)(5)(ii) of this section:

Example 1. A owns all 100 shares in X, a calendar year S corporation. For X's taxable year ending December 31, 2006, A has zero basis in the shares and X does not have any indebtedness to A. For the 2006 taxable year, X had \$100 in losses that A cannot use because of the basis limitation in section 1366(d)(1) and that are treated as incurred by the corporation with respect to A in the following taxable year. Halfway through the 2007 taxable year, A transfers 50 shares to B, A's former spouse in a transfer to which section 1041(a) applies. In the 2007 taxable year, X has \$80 in losses. On A's 2007 individual income tax return, A may use the entire \$100 carryover loss from 2006, as well as A's share of the \$80 2007 loss determined under section 1377(a) (\$60), assuming A acquires sufficient basis in the X stock. On B's 2007 individual income tax return, B may use B's share of the \$80 2007 loss determined under section 1377(a) (\$20), assuming B has sufficient basis in the X stock. If any disallowed 2006 loss is disallowed to A under section 1366(d)(1) in 2007, that loss is prorated between A and B based on their stock ownership at the beginning of 2008. On B's 2008 individual income tax return, B may use that loss, assuming B acquires sufficient basis in the X stock. If neither A nor B acquires any basis during the 2007 taxable year, then as of the beginning of 2008, the corporation will be treated as incurring \$50 of loss with respect to A and

\$50 of loss with respect to B for the \$100 of disallowed 2006 loss, and the corporation will be treated as incurring \$60 of loss with respect to A and \$20 with respect to B for the \$80 of disallowed 2007 loss.

Example 2. Assume the same facts as *Example 1*, except that during the 2007 taxable year, A acquires \$10 of basis in A's shares in X. For the 2007 taxable year, A may claim a \$10 loss deduction, which represents \$6.25 of the disallowed 2006 loss of \$100 and \$3.75 of A's 2007 loss of \$60. The disallowed 2006 loss is reduced to \$93.75. As of the beginning of 2008, the corporation will be treated as incurring half of the remaining \$93.75 of loss with respect to A and half of that loss with respect to B for the remaining \$93.75 of disallowed 2006 loss, and if B does not acquire any basis during 2007, the corporation will be treated as incurring \$56.25 of loss with respect to A and \$20 with respect to B for the remaining disallowed 2007 loss.

(6) *Basis of stock acquired by gift.* For purposes of section 1366(d)(1)(A) and paragraphs (a)(1)(i) and (2) of this section, the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(b) *Special rules for carryover of disallowed losses and deductions to post-termination transition period described in section 1377(b)—(1) In general.* If, for the last taxable year of a corporation for which it was an S corporation, a loss or deduction was disallowed to a shareholder by reason of the limitation in paragraph (a) of this section, the loss or deduction is treated under section 1366(d)(3) as incurred by that shareholder on the last day of any post-termination transition period (within the meaning of section 1377(b)).

(2) *Limitation on losses and deductions.* The aggregate amount of losses and deductions taken into account by a shareholder under paragraph (b)(1) of this section cannot exceed the adjusted basis of the shareholder's stock in the corporation determined at the close of the last day of the post-termination transition period. For this purpose, the adjusted basis of a shareholder's stock in the corporation is determined at the close of the last day of the post-termination transition period without regard to any reduction required under paragraph (b)(4) of this section. If a shareholder disposes of a share of stock prior to the close of the last day of the post-termination transition period, the adjusted basis of that share is its basis

as of the close of the day of disposition. Any losses and deductions in excess of a shareholder's adjusted stock basis are permanently disallowed. For purposes of section 1366(d)(3)(B) and this paragraph (b)(2), the basis of stock in a corporation acquired by gift is the basis of the stock that is used for purposes of determining loss under section 1015(a).

(3) *Limitation on losses and deductions allocated to each item.* If the aggregate amount of losses and deductions treated as incurred by the shareholder under paragraph (b)(1) of this section exceeds the adjusted basis of the shareholder's stock determined under paragraph (b)(2) of this section, the limitation on losses and deductions under section 1366(d)(3)(B) must be allocated among each loss or deduction. The amount of the limitation allocated to each loss or deduction is an amount that bears the same ratio to the amount of the limitation as the amount of each loss or deduction bears to the total of all the losses and deductions.

(4) *Adjustment to the basis of stock.* The shareholder's basis in the stock of the corporation is reduced by the amount allowed as a deduction by reason of this paragraph (b). For rules regarding adjustments to the basis of a shareholder's stock in an S corporation, see § 1.1367-1.

(c) *Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions—(1) Liquidations and reorganizations.* If a corporation acquires the assets of an S corporation in a transaction to which section 381(a) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Thus, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, a post-termination transition pe-

riod arises the day after the last day that an S corporation was in existence and the rules provided in paragraph (b) of this section apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. See the special rules under section 1377 for the availability of the post-termination transition period if the acquiring corporation is a C corporation.

(2) *Corporate separations to which section 368(a)(1)(D) applies.* If an S corporation transfers a portion of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, any loss or deduction disallowed under paragraph (a) of this section with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. Such allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder's stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.

[T.D. 8852, 64 FR 71646, Dec. 22, 1999, as amended by T.D. 9422, 73 FR 47531, Aug. 14, 2008]

§ 1.1366-3 Treatment of family groups.

(a) *In general.* Under section 1366(e), if an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to those items