

Internal Revenue Service, Treasury

§ 1.1377-1

\$20,000 of the excess net passive income is attributable to the net capital gain (\$45,000 × (\$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 × ((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]

§ 1.1377-0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1377-1 through 1.1377-3:

§ 1.1377-1 Pro rata share.

- (a) Computation of pro rata shares.
 - (1) In general.
 - (2) Special rules.
 - (i) Days on which stock has not been issued.
 - (ii) Determining shareholder for day of stock disposition.
 - (iii) Shareholder trust conversions.
 - (b) Election to terminate year.
 - (1) In general.
 - (2) Affected shareholders.
 - (3) Effect of the terminating election.
 - (i) In general.
 - (ii) Due date of S corporation return.
 - (iii) Taxable year of inclusion by shareholder.
 - (iv) S corporation that is a partner in a partnership.
 - (4) Determination of whether an S shareholder's entire interest has terminated.
 - (5) Time and manner of making a terminating election.
 - (i) In general.
 - (ii) Affected shareholders required to consent.
 - (iii) More than one terminating election.
 - (c) Examples.
- § 1.1377-2 Post-termination transition period.*
- (a) In general.
 - (b) Special rules for post-termination transition period.
 - (c) Determination defined.
 - (d) Date a determination becomes effective.
 - (1) Determination under section 1313(a).
 - (2) Written agreement.

- (3) Implied agreement.

§ 1.1377-3 Effective date.

[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 Code and this section, each shareholder's pro rata share of any S corporation item described in section 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day. See paragraph (b) of this section for rules pertaining to the computation of each shareholder's pro rata share when an election is made under section 1377(a)(2) to treat the taxable year of an S corporation as if it consisted of two taxable years in the case of a termination of a shareholder's entire interest in the corporation. See § 1.460-4(k)(3)(iv)(D) for rules relating to the computation of the shareholders' pro rata share of S corporation's income or loss from a contract accounted for under a long-term contract method of accounting.

(2) *Special rules*—(i) *Days on which stock has not been issued.* Solely for purposes of determining a shareholder's pro rata share of an item for a taxable year under section 1377(a) and this section, the beneficial owners of the corporation are treated as the shareholders of the corporation for any day on which the corporation has not issued any stock.

(ii) *Determining shareholder for day of stock disposition.* A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

(iii) *Shareholder trust conversions.* If, during the taxable year of an S corporation, a trust that is an eligible shareholder of the S corporation converts from a trust described in section 1361(c)(2)(A)(i), (ii), (iii), or (v) for the

first part of the year to a trust described in a different subpart of section 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts. The first day that a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) is treated as an S corporation shareholder is the effective date of the QSST or ESBT election. Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of paragraph (b) of this section, unless the trust was a trust described in section 1361(c)(2)(A)(ii) or (iii) before the conversion.

(b) *Election to terminate year*—(1) *In general.* If a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year and the corporation and all affected shareholders agree, the S corporation may elect under section 1377(a)(2) and this paragraph (b) (terminating election) to apply paragraph (a) of this section to the affected shareholders as if the corporation's taxable year consisted of two separate taxable years, the first of which ends at the close of the day on which the shareholder's entire interest in the S corporation is terminated. If the event resulting in the termination of the shareholder's entire interest also constitutes a qualifying disposition as described in § 1.1368-1(g)(2)(i), the election under § 1.1368-1(g)(2) cannot be made. An S corporation may not make a terminating election if the cessation of a shareholder's interest occurs in a transaction that results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation. (See section 1362(e)(3) for an election to have items assigned to each short taxable year under normal tax accounting rules in the case of a termination of a corporation's election to be an S corporation.) A terminating election is irrevocable and is effective only for the terminating event for which it is made.

(2) *Affected shareholders.* For purposes of the terminating election under section 1377(a)(2) and paragraph (b) of this section, the term *affected shareholders* means the shareholder whose interest

is terminated and all shareholders to whom such shareholder has transferred shares during the taxable year. If such shareholder has transferred shares to the corporation, the term *affected shareholders* includes all persons who are shareholders during the taxable year.

(3) *Effect of the terminating election*—(i) *In general.* An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for all affected shareholders for purposes of allocating items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account, earnings and profits, and basis; and determining the tax effect of a distribution. An S corporation that makes a terminating election must assign items of income (including tax-exempt income), loss, deduction, and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

(ii) *Due date of S corporation return.* A terminating election does not affect the due date of the S corporation's return required to be filed under section 6037(a) for a taxable year (determined without regard to a terminating election).

(iii) *Taxable year of inclusion by shareholder.* A terminating election does not affect the taxable year in which an affected shareholder must take into account the affected shareholder's pro rata share of the S corporation's items of income, loss, deduction, and credit.

(iv) *S corporation that is a partner in a partnership.* A terminating election by an S corporation that is a partner in a partnership is treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (relating to closing the partnership taxable year), if the taxable year of the partnership ends after the shareholder's interest is terminated and within the taxable year of the S corporation (determined without regard to any terminating election) for which the terminating election is made.

(4) *Determination of whether an S shareholder's entire interest has terminated.* For purposes of the terminating

election under section 1377(a)(2) and paragraph (b) of this section, a shareholder's entire interest in an S corporation is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of any stock (including an interest treated as stock under § 1.1361-1(l)) that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.

(5) *Time and manner of making a terminating election*—(i) *In general.* An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return required to be filed under section 6037(a) (that is, a Form 1120S) for the taxable year during which a shareholder's entire interest is terminated. A single election statement may be filed by the S corporation for all terminating elections for the taxable year. The election statement must include—

(A) A declaration by the S corporation that it is electing under section 1377(a)(2) and this paragraph (b) to treat the taxable year as if it consisted of two separate taxable years;

(B) Information setting forth when and how the shareholder's entire interest was terminated (for example, a sale or gift);

(C) The signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury, except that for taxable years beginning after December 31, 2002, the

election statement described in § 1.1377-1(b)(5)(i) of this section shall be verified, and the requirement of this paragraph (b)(5)(i)(C) is satisfied, by the signature on the Form 1120S filed by the S corporation.

(D) A statement by the corporation that the corporation and each affected shareholder consent to the S corporation making the terminating election.

(ii) *Affected shareholders required to consent.* For purposes of paragraph (b)(5)(i)(D) of this section, a shareholder of the S corporation for the taxable year is a shareholder as described in section 1362(a)(2). For example, the person who under § 1.1362-6(b)(2) must consent to a corporation's S election in certain special cases is the person who must consent to the terminating election. In addition, an executor or administrator of the estate of a deceased affected shareholder may consent to the terminating election on behalf of the deceased affected shareholder.

(iii) *More than one terminating election.* A shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to a terminating election made with respect to a subsequent termination within the same taxable year unless the shareholder is an affected shareholder with respect to the subsequent termination.

(c) *Examples.* The following examples illustrate the provisions of this section:

Example 1. Shareholder's pro rata share in the case of a partial disposition of stock. (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells 50 shares of X stock to C. Thus, in 1997, A owned 50 percent of the outstanding shares of X on each day of X's 1997 taxable year, B owned 50 percent on each day from January 6, 1997, to July 24, 1997 (200 days), and 25 percent from July 25, 1997, to December 31, 1997 (160 days), and C owned 25 percent from July 25, 1997, to December 31, 1997 (160 days).

(ii) Because B's entire interest in X is not terminated when B sells 50 shares to C on July 24, 1997, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section for B's sale of 50 shares to C. Although B's sale of 50 shares to C is a qualifying disposition under § 1.1368-

1(g)(2)(i), X does not make an election to terminate its taxable year under § 1.1368-1(g)(2). During its 1997 taxable year, X has nonseparately computed income of \$720,000.

(iii) For each day in X's 1997 taxable year, A's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$720,000/360 \text{ days} \times 50\%$). Thus, A's pro rata share of X's nonseparately computed income for 1997 is \$360,000 ($\$1,000 \times 360 \text{ days}$). B's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$720,000/360 \times 50\%$) for the first 200 days of X's 1997 taxable year, and \$500 ($\$720,000/360 \times 25\%$) for the following 160 days in 1997. Thus, B's pro rata share of X's nonseparately computed income for 1997 is \$280,000 ($(\$1,000 \times 200 \text{ days}) + (\$500 \times 160 \text{ days})$). C's daily pro rata share of X's nonseparately computed income is \$500 ($\$720,000/360 \times 25\%$) for 160 days in 1997. Thus, C's pro rata share of X's nonseparately computed income for 1997 is \$80,000 ($\$500 \times 160 \text{ days}$).

Example 2. Shareholder's pro rata share when an S corporation makes a terminating election under section 1377(a)(2). (i) On January 6, 1997, X incorporates as a calendar year corporation, issues 100 shares of common stock to each of A and B, and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells B's entire 100 shares of X stock to C. With the consent of B and C, X makes an election under section 1377(a)(2) and paragraph (b) of this section for the termination of B's entire interest arising from B's sale of 100 shares to C. As a result of the election, the pro rata shares of B and C are determined as if X's taxable year consisted of two separate taxable years, the first of which ends on July 24, 1997, the date B's entire interest in X terminates. Because A is not an affected shareholder as defined by section 1377(a)(2)(B) and paragraph (b)(2) of this section, the treatment as separate taxable years does not apply to A.

(ii) During its 1997 taxable year, X has nonseparately computed income of \$720,000. Under X's normal method of accounting, \$200,000 of the \$720,000 of nonseparately computed income is allocable to the period of January 6, 1997, through July 24, 1997 (the first deemed taxable year), and the remaining \$520,000 is allocable to the period of July 25, 1997, through December 31, 1997 (the second deemed taxable year).

(iii) B's pro rata share of the \$200,000 of nonseparately computed income for the first deemed taxable year is determined by assigning the \$200,000 of nonseparately computed income to each day of the first deemed taxable year ($\$200,000/200 \text{ days} = \$1,000 \text{ per day}$). Because B held 50% of X's authorized and issued shares on each day of the first deemed taxable year, B's daily pro rata share for each day of the first deemed taxable year is \$500 ($\$1,000 \text{ per day} \times 50\%$). Thus, B's pro rata share of the \$200,000 of nonseparately computed income for the first deemed tax-

able year is \$100,000 ($\$500 \text{ per day} \times 200 \text{ days}$). B must report this amount for B's taxable year with or within which X's full taxable year ends (December 31, 1997).

(iv) C's pro rata share of the \$520,000 of nonseparately computed income for the second deemed taxable year is determined by assigning the \$520,000 of nonseparately computed income to each day of the second deemed taxable year ($\$520,000/160 \text{ days} = \$3,250 \text{ per day}$). Because C held 50% of X's authorized and issued shares on each day of the second deemed taxable year, C's daily pro rata shares for each day of the second deemed taxable year is \$1,625 ($\$3,250 \text{ per day} \times 50\%$). Therefore, C's pro rata share of the \$520,000 of nonseparately computed income is \$260,000 ($\$1,625 \text{ per day} \times 160 \text{ days}$). C must report this amount for C's taxable year with or within which X's full taxable year ends (December 31, 1997).

Example 3. Effect of conversion of a qualified subchapter S trust (QSST) to an electing small business trust (ESBT). (i) On January 1, 2003, Trust receives stock of S corporation. Trust's current income beneficiary makes a timely QSST election under section 1361(d)(2), effective January 1, 2003. Subsequently, the trustee and current income beneficiary of Trust elect, pursuant to § 1.1361-1(j)(12), to terminate the QSST election and convert to an ESBT, effective July 1, 2004. The taxable year of S corporation is the calendar year. In 2004, Trust's pro rata share of S corporation's nonseparately computed income is \$100,000.

(ii) For purposes of computing the income allocable to the QSST and to the ESBT, Trust is treated as a QSST through June 30, 2004, and Trust is treated as an ESBT beginning July 1, 2004. Pursuant to section 1377(a)(1), the pro rata share of S corporation income allocated to the QSST is \$49,727 ($\$100,000 \times 182 \text{ days}/366 \text{ days}$), and the pro rata share of S corporation income allocated to the ESBT is \$50,273 ($\$100,000 \times 184 \text{ days}/366 \text{ days}$).

[T.D. 8696, 61 FR 67456, Dec. 23, 1996, as amended by T.D. 8994, 67 FR 34401, May 14, 2002; T.D. 9100, 68 FR 70706, Dec. 19, 2003; T.D. 9137, 69 FR 42559, July 16, 2004; T.D. 9300, 71 FR 71043, Dec. 8, 2006]

§ 1.1377-2 Post-termination transition period.

(a) *In general.* For purposes of subchapter S of chapter 1 of the Internal Revenue Code (Code) and this section, the term *post-termination transition period* means—

(1) The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—