Dividends distributed by a C corporation from current earnings and profits are attributable to active earnings and profits in the same proportion as current active earnings and profits bear to total current earnings and profits of the C corporation.

(2) Distributions from accumulated earnings and profits. Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

(3) Adjustments to active earnings and profits. For purposes of applying paragraph (c)(1) or (2) of this section to a distribution, the active earnings and profits of a corporation shall be reduced by the amount of any prior distribution properly treated as attributable to active earnings and profits from the same taxable year:

(i) The current earnings and profits, accumulated earnings and profits, and active earnings and profits of the common parent shall be determined under the principles of § 1.1502–33 (relating to earnings and profits of any member of a consolidated group owning stock of another member); and

(ii) The gross receipts of the common parent shall be the sum of the gross receipts of each member of the consolidated group (including the common parent), adjusted to eliminate gross receipts from intercompany transactions (as defined in § 1.1502–13(b)(1)(i)).

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

Example 1. (i) X, an S corporation, owns 85 percent of the one class of stock of Y. On December 31, 2002, Y declares a dividend of $100 ($100 to X); which is equal to Y’s current earnings and profits. In 2002, Y has total gross receipts of $1,000, $200 of which would be passive investment income if Y were an S corporation.

(ii) One-fifth ($200/$1,000) of Y’s gross receipts for 2002 is attributable to activities that would produce passive investment income. Accordingly, one-fifth of the $100 of earnings and profits is passive, and $72 (1⁄5 of $360) of the dividend from Y to X is passive investment income.

Example 2. (i) The facts are the same as in Example 1, except that Y owns 90 percent of the stock of Z. Y and Z do not join in the filing of a consolidated return. In 2002, Z has gross receipts of $15,000, $12,000 of which are derived from activities that would produce passive investment income. On December 31, 2002, Z declares a dividend of $1,000 ($900 to Y) from current earnings and profits.

(ii) Four-fifths ($12,000/$15,000) of the dividend from Z to Y are attributable to passive earnings and profits. Accordingly, $720 (4⁄5 of $900) of the dividend from Z to Y is considered gross receipts from an activity that would produce passive investment income. The $900 dividend to Y gives Y a total of $1,900 ($1,000 + $900) in gross receipts. $920 ($920 + $720) of which is attributable to passive investment income-producing activities. Under these facts, $41 ($920/$1,900 of $85) of Y’s distribution to X is passive investment income to X.

(e) Effective date. This section applies to dividends received in taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part, for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

[TD. 8859, 65 FR 3854, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000]

§ 1.1363–1 Effect of election on corporation.

(a) Exemption of corporation from income tax—(1) In general. Except as provided in this paragraph (a), a small business corporation that makes a valid election under section 1362(a) is exempt from the taxes imposed by chapter I of the Internal Revenue Code with respect to taxable years of the corporation for which the election is in effect.
§ 1.1363–2

(2) Corporate level taxes. An S corporation is not exempt from the tax imposed by section 1374 (relating to the tax imposed on certain built-in gains), or section 1375 (relating to the tax on excess passive investment income). See also section 1363(d) (relating to the recapture of LIFO benefits) for the rules regarding the payment by an S corporation of LIFO recapture amounts.

(b) Computation of corporate taxable income. The taxable income of an S corporation is computed as described in section 1363(b).

(c) Elections of the S corporation—(1) In general. Any elections (other than those described in paragraph (c)(2) of this section) affecting the computation of items derived from an S corporation are made by the corporation. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct 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 non-recognition 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