

## Notice of Proposed Rulemaking

### Treatment of Gain From the Disposition of Interest in Certain Natural Resource Recapture Property by S Corporations and Their Shareholders

PS-7-89

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1254 of the Internal Revenue Code relating to the tax treatment by S corporations and their shareholders of gain from the disposition by an S corporation (and a former S corporation) of certain natural resource recapture property (section 1254 property after enactment of the Tax Reform Act of 1986 and oil, gas, or geothermal property before enactment of the Tax Reform Act of 1986), and also rules relating to the disposition of stock in an S corporation that holds certain natural resource recapture property. Changes to the applicable tax law were made by the Tax Reform Act of 1986, and the Subchapter S Revision Act of 1982. The regulations provide the public with guidance in complying with the changed tax laws.

DATES: Written comments and requests for a public hearing must be received by February 20, 1996.

ADDRESSES: Send comments and requests for a public hearing to: CC:DOM:CORP:R (PS-7-89), Room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered to CC:DOM:CORP:R (PS-7-89), Room 5228, Internal Revenue Service Building, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: James A. Quinn, 202-622-3060 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### *Background*

### *Paperwork Reduction Act*

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer IT:FP, Washington, DC 20224. Comments on the collection of information should be received by January 22, 1996.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information is contained in §1.1254-4(c) of the proposed regulations. This information is required by the Internal Revenue Service to verify that taxpayers have reported the appropriate amount of gain as ordinary income under section 1254 when a shareholder sells stock in an S corporation that holds natural resource recapture property. The likely respondents are individuals and businesses and other for-profit institutions.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual reporting burden: **1,000 hours**.

The estimated annual burden per respondent varies from **.5 hours** to **1.5 hours**, depending on individual circumstances, with an estimated average of **1 hour**.

Estimated number of respondents: **1,000**.

Estimated annual frequency of responses: **On occasion**.

On June 11, 1980, proposed amendments to the Income Tax Regulations, 26 CFR part 1, under sections 170, 301, 312, 341, 453, 751, 1254, and 1502 of the Internal Revenue Code of 1954 (Code) were published in the Federal Register (45 FR 39512). These amendments were proposed to conform the regulations to section 205(a), (b), (c)(1) and (2) of the Tax Reform Act of 1976, Public Law 94-455, 90 Stat. 1533, and section 402(c) of the Energy Tax Act of 1978, Public Law 95-618, 92 Stat. 3202, and to make certain other technical amendments to the regulations to conform them to section 1(c) of the Act of September 12, 1966, Public Law 89-570, 80 Stat. 762, section 211(b)(6) of the Tax Reform Act of 1969, Public Law 91-172, 83 Stat. 570, and sections 1042(c)(2), 1101(d)(2), 1901(a)(93), and 2110(a) of the Tax Reform Act of 1976, 90 Stat. 1637, 1658, 1780, 1905. Section 1.1254-3 of the proposed regulations provided rules relating to the sale or exchange of stock in an electing small business corporation (hereinafter referred to as an S corporation). Because of the substantial changes in the tax treatment of S corporations since the proposed regulations were issued, the proposed regulations contained in §1.1254-3 needed to be completely revised.

This document revises and re-proposes §1.1254-3 of the above-referenced notice of proposed rulemaking as amendments to the Income Tax Regulations, 26 CFR part 1, under section 1254 of the Code, relating to S corporations (redesignated as §1.1254-4). These amendments are proposed to conform the regulations to section 5(a)(37) of the Subchapter S Revision Act of 1982, Public Law 97-354, 96 Stat. 1669, and sections 411 and 413 of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2225, 2227. The amendments are to be issued under the authority contained in sections 1254(b) and 7805 of the Code.

### *Explanation of Provisions*

These proposed regulations contain rules for applying the provisions of section 1254 to the disposition of

natural resource recapture property by an S corporation (and a former S corporation) and the disposition of S corporation stock.

The proposed regulations provide that the recognition of ordinary income under section 1254 upon the disposition of natural resource recapture property by an S corporation is generally computed at the shareholder level. Determining the amount of ordinary income to be recognized under section 1254 at the shareholder level is appropriate because the determination of section 1254 costs can be affected by shareholder elections and characteristics. See, for example, sections 59(e) and 1363(c)(2)(A). Similarly, in the case of oil and gas properties, gain on the disposition of the property and depletion with respect to the property are computed at the shareholder level. See section 613A(c)(11).

The proposed regulations also contain rules relating to the recognition of ordinary income under section 1254 upon a sale or exchange of S corporation stock. Under section 1254(b)(2), rules similar to the rules of section 751 are to be applied to that portion of the excess of the amount realized over the adjusted basis of the stock that is attributable to section 1254 costs. Pursuant to section 1254(b)(2), the proposed regulations provide that, as a general rule, a shareholder must treat any gain recognized on a sale or exchange of S corporation stock as ordinary income to the extent of the shareholder's section 1254 costs with respect to the shares sold or exchanged.

The proposed regulations provide two exceptions to the general rule for determining the amount treated as ordinary income under section 1254 upon a sale or exchange of stock. The first exception is that the general rule does not apply to the extent that the shareholder establishes that the gain is not attributable to the section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of

ordinary income under section 1254. To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

The second exception to the general rule for sales or exchanges of stock is that, in the case of a contribution of property to the S corporation prior to a stock sale or exchange pursuant to a plan a principal purpose of which is to avoid the recognition of ordinary income under section 1254, the selling or exchanging shareholder must recognize as ordinary income under section 1254 the amount of ordinary income the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold all of its natural resource recapture property the disposition of which would result in ordinary income under section 1254. Section 1.1254-4(c)(3) *Example 3* of the proposed regulations illustrates this exception.

The proposed regulations also provide rules for determining an S corporation shareholder's section 1254 costs. Generally, an S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property while in the hands of the S corporation. In the case of a person (acquiring shareholder) who acquires stock from another shareholder, the proposed regulations provide that the acquiring shareholder's section 1254 costs are zero if the acquiring shareholder's basis for the stock transferred is determined by reference to its cost (within the meaning of section 1012) or by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date). However, an acquiring shareholder's section 1254 costs include any section 1254 costs paid or incurred before the decedent's death, to the extent that the basis of the stock is reduced under section 1014(b)(9) (relating to adjustments to

basis if the property is acquired from a decedent prior to death). For stock that is acquired in a transfer that is a gift, in a transfer that is part sale or exchange and part gift, or a transfer described in section 1041, the acquiring shareholder generally acquires the section 1254 costs of the transferor but reduces the section 1254 costs by the amount of any gain treated as ordinary income under section 1254 by the transferor on the transfer.

The proposed regulations provide rules for applying section 1254 to the shareholders of an S corporation that incurred section 1254 costs while it was a C corporation (former C corporation). In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a *pro rata* share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

The proposed regulations also provide rules for applying section 1254 to a corporation that holds natural resource recapture property after the termination of its S corporation election (former S corporation). In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year for which the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A).

Because certain transactions will change the allocation to the shareholders of gain or amount realized from the natural resource recapture property if the S corporation disposes of it subsequent to these transactions, the proposed regulations require that section 1254 costs be reallocated to reflect the effects of these transactions. Transactions requiring reallocation of the section 1254 costs are transactions involving the issuance of stock by an S

corporation in a reorganization or otherwise, and transfers of natural resource recapture property to the S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction or in a reorganization).

The rules for former S corporations and the rules for allocating section 1254 costs upon certain transfers require the S corporation to determine the aggregate of its shareholders' section 1254 costs. The proposed regulations provide rules for the S corporation to apply in determining a shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation. In general, the S corporation may determine a shareholder's section 1254 costs by using written data provided by the shareholder or by applying certain assumptions.

These regulations are proposed to apply to dispositions of natural resource recapture property by an S corporation (and a former S corporation) and dispositions of S corporation stock occurring after publication of these regulations as final regulations in the Federal Register.

#### *Comments and Requests for a Public Hearing*

Before the adoption of these proposed regulations, consideration will be given to any written comments that are timely submitted (preferably an original and eight copies) to the IRS. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

#### *Special Analyses*

It has been determined that this proposed regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to

section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### *Drafting Information*

The principal author of these regulations is James A. Quinn of the Office of Assistant Chief Counsel (Pass-throughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

#### *Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

Paragraph. 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805. \* \* \*  
Section 1.1254-4 also issued under 26 U.S.C. 1254(b). \* \* \*

Par. 2. Section 1.1254-0 is amended by revising the entry for §1.1254-4 to read as follows:

*§1.1254-0 Table of contents for section 1254 recapture rules.* \* \* \*

\* \* \* \* \*

*§1.1254-4 Special rules for S corporations and their shareholders.*

- (a) In general.
- (b) Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation.
  - (1) General rule.
  - (2) Examples.
- (c) Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock.
  - (1) General rule.
  - (2) Exceptions.
  - (3) Examples.
- (d) Section 1254 costs of a shareholder.

- (e) Section 1254 costs of an acquiring shareholder after certain acquisitions.
  - (1) Basis determined under section 1012.
  - (2) Basis determined by reason of the application of section 1014(a).
  - (3) Basis determined by reason of the application of section 1014(b)(9).
  - (4) Gifts and section 1041 transfers.
- (f) Special rules for former S corporations and former C corporations.
  - (1) Section 1254 costs of an S corporation that was formerly a C corporation.
  - (2) Examples.
  - (3) Section 1254 costs of a C corporation that was formerly an S corporation.
- (g) Determination of a shareholder's section 1254 costs upon certain stock transactions
  - (1) Issuance of stock.
  - (2) Natural resource recapture property acquired in exchange for stock.
  - (3) Treatment of nonvested stock.
  - (4) Exception.
  - (5) Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation
  - (6) Examples.
- (h) Effective date.

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Par. 3. Section 1.1254-4 is amended by adding text to read as follows:

*§1.1254-4 Special rules for S corporations and their shareholders.*

(a) *In general.* This section provides rules for applying the provisions of section 1254 to S corporations and their shareholders upon the disposition by an S corporation (or a former S corporation) of natural resource recapture property and upon the disposition by a shareholder of stock of an S corporation that holds natural resource recapture property.

(b) *Determination of gain treated as ordinary income under section 1254 upon a disposition of natural resource recapture property by an S corporation—(1) General rule.* Upon a disposi-

tion of natural resource recapture property by an S corporation, the amount of gain treated as ordinary income under section 1254 is determined at the shareholder level. Each shareholder must recognize as ordinary income under section 1254 the lesser of—

(i) The shareholder's section 1254 costs with respect to the property disposed of; or

(ii) The shareholder's share of the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition (including a distribution), exceeds the adjusted basis of the property.

(2) *Examples.* The following examples illustrate the provisions of paragraph (b)(1) of this section:

*Example 1. Disposition of natural resource recapture property other than oil and gas property.* A and B are equal shareholders in X, an S corporation. On January 1, 1995, X acquires for \$90,000 an undeveloped mineral property, its sole property. During 1995, X expends and deducts \$100,000 in developing the property. On January 15, 1996, X sells the property for \$250,000 when X's basis in the property is \$90,000. Thus, X recognizes gain of \$160,000 on the sale. A and B's share of the \$160,000 gain recognized is \$80,000 each. Each shareholder has \$50,000 of section 1254 costs with respect to the property. Under these circumstances, A and B each are required to recognize \$50,000 of the \$80,000 of gain on the sale of the property as ordinary income under section 1254.

*Example 2. Disposition of oil and gas property the adjusted basis of which is allocated to the shareholders under section 613A(c)(11).* C and D are equal shareholders in Y, an S corporation. On January 1, 1995, Y acquires for \$150,000 an undeveloped oil and gas property, its sole property. During 1995, Y expends in developing the property \$40,000 in intangible drilling costs which it elects to expense under section 263(c). On January 15, 1996, Y sells the property for \$200,000. C and D's share of the \$200,000 amount realized on the sale is \$100,000 each. C and D each have a basis of \$75,000 in the property and \$20,000 of section 1254 costs with respect to the property. Under these circumstances, C and D each are required to recognize \$20,000 of the \$25,000 gain on the sale of the property as ordinary income under section 1254.

(c) *Character of gain recognized by a shareholder upon a sale or exchange of S corporation stock—*(1) *General rule.* Except as provided in paragraph (c)(2) of this section, if an S corporation shareholder recognizes gain upon a sale or exchange of stock in the S corporation (determined without regard to section 1254), the gain is treated as ordinary income under section 1254 to the extent of the shareholder's section

1254 costs (with respect to the shares sold or exchanged).

(2) *Exceptions—*(i) *Gain not attributable to section 1254 costs—*(A) *General rule.* Paragraph (c)(1) of this section does not apply to any portion of the gain recognized on the sale or exchange of the stock that the taxpayer establishes is not attributable to section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of ordinary income under section 1254.

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)-(2)(i)(A) of this section, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section 1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock. This reduced amount realized is used in determining

any gain or loss on the sale or exchange.

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

*Example 1. Application of general rule upon a sale of S corporation stock.* C and D are equal shareholders in Y, an S corporation. As of January 1, 1995, Y holds two mining properties: Blackacre, with an adjusted basis of \$5,000 and a fair market value of \$35,000, and Whiteacre, with an adjusted basis of \$20,000 and a fair market value of \$15,000. Y also holds securities with a basis of \$5,000 and a fair market value of \$10,000. On January 1, 1995, D sells 50 percent of D's Y stock to E for \$15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is \$7,500, and D has \$18,000 of section 1254 costs with respect to Blackacre and \$12,000 of section 1254 costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize \$7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in ordinary income to D under section 1254), the \$7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes \$7,500 of ordinary income under this paragraph (c).

*Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs.* Assume the same facts as in *Example 1*, except that Blackacre has a fair market value of \$25,000, and the securities have a fair market value of \$20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize \$5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1995 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the \$7,500 gain recognized by D, \$5,000 is ordinary income under this paragraph (c).

*Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to avoid recognition of ordinary income under section 1254.* H owns all of the stock of Z, an S corporation. As of January 1, 1995, H has \$3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of \$5,000 and a fair market value of \$8,000. H has a basis of \$5,000 in Z stock, which has a fair market value of \$8,000. On January 1, 1995, H contributes securities to Z which have a basis of \$7,000 and a fair market value of \$4,000. On April 15, 1995, H sells all of the Z stock to J for \$12,000. On that date, H's adjusted basis in the Z stock is also \$12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph

(c)(2)(ii) of this section, H must recognize \$3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock (\$12,000) by \$3,000. As a result, H also recognizes a \$3,000 capital loss on the sale of the stock (\$9,000 amount realized less \$12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* An S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the shareholder's section 1254 costs with respect to the property in the hands of the S corporation. See §1.1254-1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions—(1) Basis determined under section 1012.* If stock in an S corporation that holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined by reason of the application of section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined by reason of the application of section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be

reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, or in a transfer that is described in section 1041(a), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for former S corporations and former C corporations—(1) Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a *pro rata* share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

(2) *Examples.* The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

*Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i)* Y is a C corporation that elects to be an S corporation effective January 1, 1996. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of \$20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1996, Oil Well has a value of \$200,000 and a basis of \$100,000. Thus, under section 1374, Y's net unrealized built-in gain is \$100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under §1.1254-4(f)(1). In addition, A has a basis in A's Y stock of \$100,000.

(ii) On November 1, 1996, Y sells Oil Well for \$250,000. During 1996, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a

tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of \$20,000 and net capital gain of \$95,000 (\$130,000 minus \$35,000) on the sale.

*Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i)* Assume the same facts as in *Example 1(i)*. On November 1, 1996, A sells all of A's Y stock to P for \$250,000. A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain.

(ii) On November 2, 1996, Y sells Oil Well for \$250,000. During 1996, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000), which is recognized as capital gain. Consequently, P recognizes net capital gain of \$115,000 (\$150,000 minus \$35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an S corporation.* In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year that the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders' section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions—(1) Issuance of stock.* Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization or otherwise—

(i) Each recipient of shares must be allocated a *pro rata* share (determined solely with respect to the shares issued in the transaction) of the aggregate of

the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs immediately before the issuance multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock.* If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to its shareholders a *pro rata* share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under §1.1254-3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of §1.83-3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation—(i) In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(i)(A) (written data) or paragraph (g)(5)(i)(B) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(i)(A) of this section and of others under paragraph (g)(5)(i)(B) of this section.

(A) *Written data.* An S corporation may determine a shareholder's section

1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(i)(B) of this section in determining a shareholder's section 1254 costs.

(B) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(i)(A) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs.

(1) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(2) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

*Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction.* As of January 1, 1996, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of \$2,000 and an adjusted basis of \$2,000. On January 1, 1996, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of \$8,000 and an adjusted basis of \$5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled \$6,000. Under §1.1254-2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under §1.1254-3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal \$6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a *pro rata* share of X's section 1254

costs. The *pro rata* share of X's section 1254 costs that is allocated to A equals \$1,200 (20 percent interest in X multiplied by X's \$6,000 of section 1254 costs). The *pro rata* share of X's section 1254 costs that is allocated to B equals \$4,800 (80 percent interest in X multiplied by X's \$6,000 of section 1254 costs).

*Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property.* As of January 1, 1996, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of \$20,000 and an adjusted basis of \$14,000. A's and B's section 1254 costs with respect to Property P are \$4,000 and \$1,500, respectively. On January 1, 1996, C contributes \$20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a *pro rata* share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(i)(B) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal \$4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal \$1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals \$6,000. C's *pro rata* share of the \$6,000 of section 1254 costs equals \$3,000 (C's 50 percent interest in X multiplied by \$6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by \$2,000 (A's actual section 1254 costs (\$4,000) multiplied by 50 percent). B's section 1254 costs are reduced by \$750 (B's actual section 1254 costs (\$1,500) multiplied by 50 percent).

*Example 3. Merger involving an S corporation that holds natural resource recapture property.* X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of \$120,000 and an adjusted basis of \$40,000. A has section 1254 costs with respect to the property of \$60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of \$120,000 and basis of \$120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a *pro rata* share of its \$60,000 of section 1254 costs. Thus, A and B are each allocated \$30,000 of section 1254 costs (50 percent interest in X, each, multiplied by \$60,000).

(h) *Effective date.* This section applies to dispositions of natural resource recapture property by an S corporation (and a former S corporation) and dispositions of S corporation stock occurring after [publication of these regulations as final regulations in the Federal Register].

Margaret Milner Richardson,  
Commissioner of  
Internal Revenue.

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