(2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and

(3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

(b) Allocation rule. If an S corporation's pre-limitation amount for any taxable year exceeds its net recognized built-in gain for that year, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.

(c) Recognized built-in gain carryover. If an S corporation's net recognized built-in gain for any taxable year is equal to its taxable income limitation, the amount by which its pre-limitation amount exceeds its net recognized built-in gain for the succeeding taxable year is a recognized built-in gain carryover included in its pre-limitation amount for the succeeding taxable year. The recognized built-in gain carryover consists of that portion of each item of income, gain, loss, and deduction not included in the S corporation's net recognized built-in gain for the year the carryover arose, as determined under paragraph (b) of this section.

(d) Accounting methods. In determining its taxable income for pre-limitation amount and taxable income limitation purposes, a corporation must use the accounting method(s) it uses for tax purposes as an S corporation.

(e) Example. The rules of this section are illustrated by the following example.

Example: Net recognized built-in gain. X is a calendar year C corporation that elects to become an S corporation on January 1, 1996. X has a net unrealized built-in gain of $50,000 and no net operating loss or capital loss carryforwards. In 1996, X has a pre-limitation amount of $20,000, consisting of ordinary income of $15,000 and capital gain of $5,000, a taxable income limitation of $9,600, and a net unrealized built-in gain limitation of $50,000. Therefore, X's net recognized built-in gain for 1996 is $9,600, because that is the least of the three amounts described in paragraph (a) of this section. Under paragraph (b) of this section, X's net recognized built-in gain consists of recognized built-in ordinary income of $7,200 ($15,000×($9,600/$20,000)=7,200) and recognized built-in capital gain of $2,400 ($5,000×($9,600/$20,000)=2,400). Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of $10,400 ($20,000−$9,600=$10,400), consisting of $7,800 ($15,000−$7,200=$7,800) of recognized built-in ordinary income and $2,600 ($5,000−$2,400=$2,600) of recognized built-in capital gain.

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(b)(2) of this section, such net unrealized built-in gain is adjusted to eliminate any effect that any built-in gain or built-in loss in the redeemed or canceled stock (other than stock with respect to which a loss under section 165 is claimed) had on the initial computation of net unrealized built-in gain for that pool of assets. For purposes of this paragraph, stock described in section 1374(d)(6) shall be treated as taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation.

(2) Limitations on adjustment—(i) Recognized built-in gain or loss. Net unrealized built-in gain for a pool of assets of the S corporation is only adjusted under paragraph (b)(1) of this section to reflect built-in gain or built-in loss in the redeemed or canceled stock that has not resulted in recognized built-in gain or recognized built-in loss during the recognition period.

(ii) Anti-duplication rule. Paragraph (b)(1) of this section shall not be applied to duplicate an adjustment to the net unrealized built-in gain for a pool of assets made pursuant to paragraph (b)(1) of this section.

(3) Effect of adjustment. Any adjustment to the net unrealized built-in gain made pursuant to this paragraph (b) only affects computations of the amount subject to tax under section 1374 for taxable years that end on or after the date of the acquisition to which section 1374(d)(8) applies.

(4) Pool of assets. For purposes of this section, a pool of assets means—

(i) The assets held by the corporation on the first day it became an S corporation, if the corporation was previously a C corporation; or

(ii) The assets the S corporation acquired from a C corporation in a section 1374(d)(8) transaction.

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

Example 1. Computation of net unrealized built-in gain. (i) (A) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Factory</td>
<td>$500,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>300,000</td>
<td>0</td>
</tr>
</tbody>
</table>

Total: $1,050,000

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X’s amount realized would be $1,050,000 ($750,000 cash received + $300,000 liabilities assumed = $1,050,000). Thus, X’s net unrealized built-in gain is determined as follows:

| Amount realized            | $1,050,000 |
| Deduction allowed (A/P)    | (100,000)  |
| Basis of X’s assets        | (900,000)  |
| Section 481 adjustments    | 60,000     |
| Net unrealized built-in gain | 110,000    |

Example 2. Adjustment to net unrealized built-in gain for built-in gain in eliminated C corporation stock. (i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X’s assets (the first pool of assets) have a net unrealized built-in gain of $15,000. Among the assets in the first pool of assets is all of the outstanding stock of Y, a C corporation, with a fair market value of $33,000 and an adjusted basis of $18,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, and as a result has $10,000 of recognized built-in gain. X has had no other recognized built-in gain or built-in loss. X’s taxable income limitation for 2009 is $50,000. Effective June 1, 2009, X elects under section 1361 to treat Y as a qualified subchapter S subsidiary (QSub). The election is treated as a transfer of Y’s assets to X in a liquidation to which sections 332 and 337(a) apply.

(ii) Under paragraph (b) of this section, the net unrealized built-in gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, therefore, is decreased by $15,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $0.

(iii) Under § 1.1374–2(a), X’s net recognized built-in gain for any taxable year equals the least of X’s pre-limitation amount, taxable income limitation, and net unrealized built-in gain limitation. In 2009, X’s pre-limitation
Example 4. Adjustment to net unrealized built-in gain in case of prior gain recognition.

(i) X, a calendar year C corporation, elects to become an S corporation effective January 1, 2005. On that date, X's assets (the first pool of assets) have a net unrealized built-in gain of $10,000, so X's net unrealized built-in gain limitation is $0. The net unrealized built-in gain of the first pool of assets is $10,000 of which is treated as gain to X for 2005. On January 1, 2006, Y transfers its assets to X in a liquidation to which sections 332 and 337(a) apply. (ii) Under paragraph (b) of this section, the net unrealized built-in gain of the first pool of assets is adjusted to account for the elimination of the Y stock in the liquidation. The net unrealized built-in gain of the first pool of assets, however, can only be adjusted to reflect the amount of built-in gain that was inherent in the Y stock on January 1, 2005 that has not resulted in recognized built-in gain during the recognition period. Accordingly, for taxable years ending after June 1, 2009, the net unrealized built-in gain of the first pool of assets is $0. The net unrealized built-in gain limitation for 2009 is $0.