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(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 taxable income limitation 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.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374–3 Net unrealized built-in gain.

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Adjustment to net unrealized built-in gain*—(1) *In general.* If section 1374(d)(8) applies to an S corporation's acquisition of assets, some or all of the stock of the corporation from which such assets were acquired was taken into account in the computation of the net unrealized built-in gain for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to the limitations of paragraph (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:

Assets	FMV	Basis
Factory	$500,000	$900,000
Accounts Receivable	300,000	0
Goodwill	250,000	0
Total	1,050,000	900,000

Liabilities	Amount
Mortgage	$200,000
Accounts Payable	100,000
Total	300,000

(B) Further, X must include a total of $60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(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 amount is $10,000, X's taxable income limitation is $50,000, and X's net unrealized built-in gain limitation is $0. Because the net unrealized built-in gain of the first pool of assets has been adjusted to $0, despite the $10,000 of recognized built-in gain in 2009, X has $0 net recognized built-in gain for the taxable year ending on December 31, 2009.

Example 3. Adjustment to net unrealized built-in gain for built-in loss 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 negative $5,000. Among the assets in the first pool of assets is 10 percent of the outstanding stock of Y, a C corporation, with a fair market value of $18,000 and an adjusted basis of $33,000. On March 1, 2009, X sells an asset that it owned on January 1, 2005, resulting in $8,000 of recognized built-in gain. X has had no other recognized built-in gains or built-in losses. X's taxable income limitation for 2009 is $50,000. On June 1, 2009, Y transfers its assets to X in a reorganization under section 368(a)(1)(C).

(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 reorganization. The net unrealized built-in gain of the first pool of assets, therefore, is increased by $15,000, the amount by which the adjusted basis of the Y stock exceeded its fair market value 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 $10,000.

(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 amount is $8,000 and X's taxable income limitation is $50,000. The net unrealized built-in gain of the first pool of assets has been adjusted to $10,000, so X's net unrealized built-in gain limitation is $10,000. X, therefore, has $8,000 net recognized built-in gain for the taxable year ending on December 31, 2009. X's net unrealized built-in gain limitation for 2010 is $2,000.

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 $30,000. 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 $45,000 and an adjusted basis of $10,000. Y has no current or accumulated earnings and profits. On April 1, 2007, Y distributes $18,000 to X, $8,000 of which is treated as gain to X from the sale or exchange of property under section 301(c)(3). That $8,000 is recognized built-in gain to X under section 1374(d)(3), and results in $8,000 of net recognized built-in gain to X for 2007. X's net unrealized built-in gain limitation for 2008 is $22,000. On June 1, 2009, 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 that 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. In this case, therefore, the net unrealized built-in gain of the first pool of assets cannot be reduced by more than $27,000 ($35,000, the amount by which the fair market value of the Y stock exceeded its adjusted basis as of January 1, 2005, minus $8,000, the recognized built-in gain with respect to the stock 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 $3,000. The net unrealized built-in gain limitation for 2009 is $0.

[T.D. 8579, 59 FR 66464, Dec. 27, 1994, as amended by T.D. 9180, 70 FR 8728, Feb. 23, 2005]

§ 1.1374–4 Recognized built-in gain or loss.

(a) *Sales and exchanges*—(1) *In general*. Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property*. For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

(3) *Examples*. The rules of this paragraph (a) are illustrated by the following examples.

Example 1. Production and sale of oil. X is a C corporation that purchased a working interest in an oil and gas property for $100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of $250,000 and an adjusted basis of $50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for $75,000, and includes that amount in gross income. Under paragraph