(iii) To the extent the gain that X recognizes on the asset sales in 2006, 2007, and 2008 reflects built-in gain inherent in such assets in X's hands on January 1, 2004, such gain is subject to tax under section 1374 as amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

§1.1375–1 Tax imposed when passive investment income of corporation having subchapter C earnings and profits exceed 25 percent of gross receipts.

(a) General rule. For taxable years beginning after 1981, section 1375(a) imposes a tax on the income of certain S corporations that have passive investment income. In the case of a taxable year beginning during 1982, an electing small business corporation may elect to have the rules under this section not apply. See the regulations under section 1362 for rules on the election. For purposes of this section, the term S corporation shall include an electing small business corporation under prior law. This tax shall apply to an S corporation for a taxable year if the S corporation has—

(1) Subchapter C earnings and profits at the close of such taxable year, and

(2) Gross receipts more than 25 percent of which are passive investment income.

If the S corporation has no subchapter C earnings and profits at the close of the taxable year (because, for example, such earnings and profits were distributed in accordance with section 1368), the tax shall not be imposed even though the S corporation has passive investment income for the taxable year. If the tax is imposed, the tax shall be computed by multiplying the excess net passive income (as defined in paragraph (b)(1) of this section) by the highest rate of tax specified in section 11(b).

(b) Definitions—(1) Excess net passive income—(i) In general. The term excess net passive income is defined in section 1375(b)(1), and can be expressed by the following formula:

\[
ENPI = NPI \times \frac{PII - (25 \times GR)}{PII}
\]

Where:
- \( ENPI \) = excess net passive income
- \( NPI \) = net passive income
- \( PII \) = passive investment income
- \( GR \) = total gross receipts

(ii) Limitation. The amount of the excess net passive income for any taxable year shall not exceed the corporation's taxable income for the taxable year (determined in accordance with section 1374(d) and §1.1374–1(d)).

(2) Net passive income. The term net passive income means—

(i) Passive investment income, reduced by

(ii) The deductions allowable under chapter I of the Internal Revenue Code of 1954 which are directly connected (within the meaning of paragraph (b)(3) of this section) with the production of such income (other than deductions allowable under section 172 and part VIII of subchapter B).

(3) Directly connected—(i) In general. For purposes of paragraph (b)(2)(ii) of this section to be directly connected with the production of income, an item of deduction must have proximate and primary relationship to the income. Expenses, depreciation, and similar items attributable solely to such income qualify for deduction.

(ii) Allocation of deduction. If an item of deduction is attributable (within the meaning of paragraph (b)(3)(i) of this section) in part to passive investment income and in part to income other than passive investment income, the deduction shall be allocated between the two types of items on a reasonable basis. The portion of any deduction so allocated to passive investment income shall be treated as proximately and primarily related to such income.

(4) Other definitions. The terms subchapter C earnings and profits, passive investment income, and gross receipts shall have the same meaning given these terms in section 1362(d)(3) and the regulations thereunder.

(c) Special rules—(1) Disallowance of credits. No credit is allowed under part IV of subchapter A of chapter I of the Code (other than section 34) against the tax imposed by section 1375(a) and this section.
(2) Coordination with section 1374. If any gain—

(i) Is taken into account in determining passive income for purposes of this section, and

(ii) Is taken into account under section 1374,

the amount of such gain taken into account under section 1374(b) and §1.1374–1(b) (1) and (2) in determining the amount of tax shall be reduced by the portion of the excess net passive income for the taxable year which is attributable (on a pro rata basis) to such gain. For purposes of the preceding sentence, the portion of excess net passive income for the taxable year which is attributable to such capital gain is equal to the amount determined by multiplying the excess net passive income by the following fraction:

\[
\frac{NCG - E}{NPI}
\]

Where:

NCG = net capital gain
NPI = net passive income.
E = Expense attributable to net capital gain.

(d) Waiver of tax in certain cases—(1) In general. If an S corporation establishes to the satisfaction of the Commissioner that—

(i) It determined in good faith that it had no subchapter C earnings and profits at the close of the taxable year, and

(ii) During a reasonable period of time after it was determined that it did have subchapter C earnings and profits at the close of such taxable year, such earnings and profits were distributed,

the Commissioner may waive the tax imposed by section 1375 for such taxable year. The S corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should waive the tax.

For example, if an S corporation establishes that in good faith and using due diligence it determined that it had no subchapter C earnings and profits at the close of a taxable year, but it was later determined on audit that it did have subchapter C earnings and profits at the close of such taxable year, and if the corporation establishes that it distributed such earnings and profits within a reasonable time after the audit, it may be appropriate for the Commissioner to waive the tax on passive income for such taxable year.

(2) Corporation’s request for a waiver. A request for waiver of the tax imposed by section 1375 shall be made in writing to the district director and shall contain all relevant facts to establish that the requirements of paragraph (d)(1) of this section are met. Such request shall contain a description of how and on what date the S corporation in good faith and using due diligence determined that it had no subchapter C earnings and profits at the close of the taxable year, a description of how and on what date it was determined that the S corporation had subchapter C earnings and profits at the close of the year and a description (including dates) of any steps taken to distribute such earnings and profits. If the earnings and profits have not yet been distributed, the request shall contain a timetable for distribution and an explanation of why such timetable is reasonable. On the date the waiver is to become effective, all subchapter C earnings and profits must have been distributed.

(e) Reduction in pass-thru for tax imposed on excess net passive income. See section 1366(f)(3) for a special rule reducing each item of the corporation’s passive investment income for purposes of section 1366(a) if a tax is imposed on the corporation under section 1375.

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

Example 1. Assume Corporation M, an S corporation, has for its taxable year total gross receipts of $200,000, passive investment income of $100,000, $60,000 of which is interest income, and expenses directly connected with the production of such interest income in the amount of $10,000. Assume also that at the end of the taxable year Corporation M has subchapter C earnings and profits. Since more than 25 percent of the Corporation M’s total gross receipts are passive investment income, and since Corporation M has subchapter C earnings and profits, Corporation M is subject to the tax imposed by section 1375. The amount of excess net passive investment income is $45,000 ($90,000 × (50,000 / 100,000)). Assume that the other $40,000 of passive investment income is attributable to net capital gain and that there are no expenses directly connected with such gain. Under these facts,
$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 / 400)). This amount is subject to the tax imposed by section 1375, notwithstanding that such amount is otherwise tax-exempt income.

§ 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. 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, each shareholder’s entire interest has terminated. (b) Election to terminate year—(i) In general. (ii) Determining shareholder for day of stock disposition. (iii) Shareholder trust conversions.

§ 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.

§ 1.1377–3 Effective date.