

Reg. Section 1.1366-1(a)(1)

Shareholder's share of items of an S corporation

(a) Determination of shareholder's tax liability.



(1) In general. An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2), (3), and (4) of this section. A shareholder's pro rata share is determined in accordance with the provisions of section 1377(a) and the regulations thereunder. The shareholder takes these items into account in determining the shareholder's taxable income and tax liability for the shareholder's taxable year with or within which the taxable year of the corporation ends. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. For the limitation on allowance of a shareholder's pro rata share of S corporation losses or deductions, see section 1366(d) and §1.1366-2.

(2) Separately stated items of income, loss, deduction, or credit. Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately. The separately stated items of the S corporation include, but are not limited to, the following items-

(i) The corporation's combined net amount of gains and losses from sales or exchanges of capital assets grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(ii) The corporation's combined net amount of gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), grouped by applicable holding periods, by applicable rate of tax under section 1(h), and by any other classification that may be relevant in determining the shareholder's tax liability;

(iii) Charitable contributions, grouped by the percentage limitations of section 170(b), paid by the corporation within the taxable year of the corporation;

(iv) The taxes described in section 901 that have been paid (or accrued) by the corporation to foreign countries or to possessions of the United States;

(v) Each of the corporation's separate items involved in the determination of credits against tax allowable under part IV of subchapter A (section 21 and following) of the Internal Revenue Code, except for any credit allowed under section 34 (relating to certain uses of gasoline and special fuels);

(vi) Each of the corporation's separate items of gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); deduction under an election to expense certain depreciable business expenses (section 179); medical, dental, etc., expenses (section 213); the additional itemized deductions for individuals provided in part VII of subchapter B (section 212 and following) of the Internal Revenue Code; and any other itemized deductions for which the limitations on itemized deductions under sections 67 or 68 applies;

(vii) Any of the corporation's items of portfolio income or loss, and expenses related thereto, as defined in the regulations under section 469;

(viii) The corporation's tax-exempt income. For purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under section 101 (certain death benefits) or section 103 (interest on state and local bonds) is tax-exempt income, while income that is excludible from gross income under section 108 (income from discharge of indebtedness) or section 109 (improvements by lessee on lessor's property) is not tax-exempt income;

(ix) The corporation's adjustments described in sections 56 and 58, and items of tax preference described in section 57; and

(x) Any item identified in guidance (including forms and instructions) issued by the Commissioner as an item required to be separately stated under this paragraph (a)(2).

(3) Nonseparately computed income or loss. Each shareholder must take into account separately the shareholder's pro rata share of the nonseparately computed income or loss of the S corporation. For this purpose, nonseparately computed income or loss means the corporation's gross income less the deductions allowed to the corporation under chapter 1 of the Internal Revenue Code, determined by excluding any item requiring separate computation under paragraph (a)(2) of this section.

(4) Separate activities requirement. An S corporation must report, and each shareholder must take into account in the shareholder's return, the shareholder's pro rata share of an S corporation's items of income, loss, deduction, or credit described in paragraphs (a)(2) and (3) of this section for each of the corporation's activities as defined in section 469 and the regulations thereunder.

(5) Aggregation of deductions or exclusions for purposes of limitations.

(i) In general. A shareholder aggregates the shareholder's separate deductions or exclusions with the shareholder's pro rata share of the S corporation's separately

stated deductions or exclusions in determining the amount of any deduction or exclusion allowable to the shareholder under subtitle A of the Internal Revenue Code as to which a limitation is imposed.

(ii) Example. The provisions of paragraph (a)(5)(i) of this section are illustrated by the following example:

Example. In 1999, Corporation M, a calendar year S corporation, purchases and places in service section 179 property costing \$10,000. Corporation M elects to expense the entire cost of the property. Shareholder A owns 50 percent of the stock of Corporation M. Shareholder A's pro rata share of this item after Corporation M applies the section 179(b) limitations is \$5,000. Because the aggregate amount of Shareholder A's pro rata share and separately acquired section 179 expense may not exceed \$19,000 (the aggregate maximum cost that may be taken into account under section 179(a) for the applicable taxable year), Shareholder A may elect to expense up to \$14,000 of separately acquired section 179 property that is purchased and placed in service in 1999, subject to the limitations of section 179(b).

(b) Character of items constituting pro rata share.

(1) In general. Except as provided in paragraph (b)(2) or (3) of this section, the character of any item of income, loss, deduction, or credit described in section 1366(a)(1)(A) or (B) and paragraph (a) of this section is determined for the S corporation and retains that character in the hands of the shareholder. For example, if an S corporation has capital gain on the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain regardless of whether the shareholder is otherwise a dealer in that type of property. Similarly, if an S corporation engages in an activity that is not for profit (as defined in section 183), a shareholder's pro rata share of the S corporation's deductions will be characterized as not for profit. Also, if an S corporation makes a charitable contribution to an organization qualifying under section 170(b)(1)(A), a shareholder's pro rata share of the S corporation's charitable contribution will be characterized as made to an organization qualifying under section 170(b)(1)(A).

(2) Exception for contribution of noncapital gain property. If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would not have produced capital gain if sold or exchanged by the shareholder or shareholders, then the gain on the sale or exchange of the property recognized by the corporation is not treated as a capital gain.

(3) Exception for contribution of capital loss property. If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder or shareholders would have produced capital loss if sold or exchanged by the shareholder or shareholders, then the loss on the sale or exchange of the property recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder or shareholders exceeded the fair market value of the property.

