

Reg. Section 1.1374-4(c)(1)

Recognized built-in gain or loss

Effective: May 15, 2002. These regulations apply to transactions on or after May 15, 2002.

(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 (a)(1) of this section, the \$75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

Example (2). Sale of oil and gas property. Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own 50 percent of Y's stock. In addition, Y owns a royalty interest in an oil and gas property with a fair market value of \$300,000 and an adjusted basis of \$200,000. Under section 613A(c)(11)(B), Y's \$200,000 adjusted basis in the royalty interest is allocated \$100,000 to A and \$100,000 to B. During 1996, A and B take depletion deductions with respect to the royalty interest of \$10,000 and \$15,000, respectively. As of January 1, 1997, A and B have a basis in the royalty interest of \$90,000 and \$85,000, respectively. On January 1, 1997, Y sells the royalty interest for \$250,000. Under paragraph (a)(1) of this section, Y has gain recognized and recognized built-in gain of \$75,000 ($\$250,000 - (\$90,000 + \$85,000) = \$75,000$) on the sale.

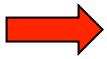
(b) Accrual method rule.

(1) Income items. Except as otherwise provided in this section, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

(2) Deduction items. Except as otherwise provided in this section, any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation). In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and §1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

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(c) Section 267(a)(2) and 404(a)(5) deductions.



(1) Section 267(a)(2). Notwithstanding paragraph (b)(2) of this section, any amount properly deducted in the recognition period under section 267(a)(2), relating to payments to related parties, is recognized built-in loss to the extent-

(i) All events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and

(ii) The amount is paid-

(A) In the first two and one-half months of the recognition period; or

(B) To a related party owning, under the attribution rules of section 267, less than 5 percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid.

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