

years for purposes of computing and allocating to each shareholder items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account (AAA), earnings and profits, and basis; and determining the tax effect of a distribution to the shareholders. This treatment is required to give full effect to treating the taxable year as two separate taxable years. The proposed regulations also require the S corporation to assign items of income, loss, deduction, and credit to each deemed separate taxable year using the corporation's normal method of accounting as determined under section 446(a). The proposed regulations provide that a terminating election does not affect the due date of the S corporation's tax return for the taxable year or the time when the shareholders must include their pro rata allocations of items from the S corporation. The proposed regulations also provide that a terminating election by an S corporation that is a partner in a partnership is treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (closing of the partnership's taxable year) if the taxable year of the partnership ends after the shareholder's interest is terminated and within the full taxable year of the S corporation for which the terminating election is made. This rule conforms terminating elections with the rule for S termination years. See § 1.1362-3(c)(1).

The proposed regulations coordinate the application of the terminating election under section 1377(a)(2) with the election under section 1362(e)(3) (election to have items assigned to each short taxable year of an S termination year under normal accounting rules rather than pro rata) and the election under § 1.1368-1(g)(2) (election to terminate the taxable year when there is a qualifying disposition). Under the proposed regulations, if a transfer results in a termination of the shareholder's entire interest as a shareholder and the transfer also constitutes a qualifying disposition under § 1.1368-1(g)(2)(i), the terminating election rules under these proposed regulations take precedence and a qualifying disposition election cannot be made. If a termination of a shareholder's entire interest results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation, however, the proposed regulations provide that the corporation may not make a terminating election. When a corporation's election to be an S corporation terminates, the portion of

the corporation's taxable year ending at the close of the day preceding the day for which the terminating event is effective is treated as an S short year, and the remainder is treated as a C short year. Thus, because the day upon which a terminating event occurs is the first day of a C short year, as of that date there is no S corporation taxable year that may be divided into two separate years under section 1377(a)(2). Under section 1362(e)(2), the income or loss for the entire S termination year is allocated on a pro rata basis between the S and C short years. However, if the corporation makes an election under section 1362(e)(3), the corporation allocates income and loss to each short taxable year under the corporation's normal tax accounting rules. Thus, when a corporation makes an election under section 1362(e)(3), a shareholder of an S corporation may achieve a result similar to the result of an election under section 1377(a)(2) and these proposed regulations (which also require an allocation of income and loss to each short taxable year under normal accounting rules).

Post-Termination Transition Period

Section 1377(b) provides that the term *post-termination transition period* (PTTP) for purposes of subchapter S of chapter 1 of the Code means: (1) The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of the day which is 1 year after such last day, or the due date for filing the return for the last taxable year as an S corporation (including extensions); and (2) the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year. The PTTP is relevant for purposes of section 1366(d)(3) (carryover of disallowed losses after the last taxable year for which a corporation is an S corporation) and section 1371(e) (distributions of money by a corporation with respect to its stock after termination of S corporation status).

The proposed regulations clarify that a PTTP arises following the termination under section 1362(d) of a corporation's S election. For example, a PTTP arises in the case of a C corporation that acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies. However, if an S corporation acquires the assets of another S corporation in a transaction to which section 381(a)(2) applies, a PTTP does not arise. Instead, under § 1.1368-2(d)(2), the acquiring S corporation succeeds to and merges its AAA with

the AAA of the distributor or transferor S corporation.

The proposed regulations clarify that the last day of a corporation's last taxable year as an S corporation is the last day of the short S taxable year under section 1362(e)(1)(A) or the date of transfer in the event that a C corporation acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies. The proposed regulations also provide that the special treatment under section 1371(e)(1) is available only to those shareholders who were shareholders in the S corporation at the time of the termination.

The proposed regulations provide additional guidance on the definition of a determination for purposes of ascertaining when a PTTP begins under section 1377(b)(1)(B). Under the proposed regulations, a determination includes a written agreement between an S corporation and the Commissioner that the corporation failed to qualify as an S corporation. The agreement must be signed by the appropriate district director and an authorized officer of the corporation. In addition, if there is no written agreement, a determination results from the expiration of the period specified in section 6226 for filing a petition for readjustment of a final S corporation administrative adjustment finding that the corporation failed to qualify as an S corporation, provided that no petition is filed prior to the expiration of the period. For corporations not subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A (dealing with the tax treatment of partnership items) a determination results from the expiration of the period for filing a petition under section 6213 for the shareholder's taxable year for which the Commissioner has made a finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period.

Effective Date

The regulations under section 1377 are proposed to apply to taxable years of an S corporation beginning after the date of publication as final regulations in the **Federal Register**.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory