

Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

### Drafting Information

The principal author of these regulations is Brian J. O'Connor, Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

### List of Subjects in 26 CFR Parts 1 and 18

Income taxes, Reporting and recordkeeping requirements.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 18 are proposed to be amended as follows:

## PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

Section 1.1377-1 also issued under 26 U.S.C. 1377 (a)(2) and (c).

**Par. 2.** Sections 1.1377-0, 1.1377-1, 1.1377-2, and 1.1377-3 are added under the heading "Small Business Corporations and Their Shareholders" to read as follows:

#### § 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:

#### Sec. 1.1377-1 *Pro rata share.*

- (a) Computation of pro rata shares.
- (1) In general.
- (2) Special rules.

- (i) Days without shareholders.
- (ii) Determining shareholder for day of stock disposition.
- (b) Election to terminate year.
- (1) In general.
- (2) Effect of the terminating election.
- (i) In general.
- (ii) Due date of S corporation return.
- (iii) Taxable year of inclusion by shareholder.
- (iv) S Corporation that is a partner in a partnership.
- (3) Determination of whether an S shareholder's entire interest has terminated.
- (4) Time and manner of making terminating election.
- (i) In general.
- (ii) Shareholders required to consent.
- (iii) More than one terminating election.
- (c) Examples.

#### Sec. 1.1377-2 *Post-termination transition period.*

- (a) In general.
- (b) When a post-termination transition period arises.
- (c) Last day of last taxable year.
- (d) Determination defined.
- (e) Time of determination.
- (1) Court decision.
- (2) Closing agreement.
- (3) Written agreement.
- (4) Implied agreement.

#### Sec. 1.1377-3 *Effective date.*

#### § 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 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.

(2) *Special rules—*(i) *Days without shareholders.* 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, an S corporation's taxable year does not include any day on which the corporation has no shareholders.

(ii) *Determining shareholder for day of stock disposition.* A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies

is treated as the shareholder for the day of the shareholder's death.

(b) *Election to terminate year—*(1) *In general.* If a shareholder's entire interest in an S corporation is terminated during the S corporation's taxable year and all persons who are shareholders during the taxable year agree (as prescribed in paragraph (b)(4) of this section), the S corporation may elect under section 1377(a)(2) and this paragraph (b) (terminating election) to treat its taxable year as if it consisted of two separate taxable years, the first of which ends at the close of the day on which the shareholder's entire interest in the S corporation is terminated. If the event resulting in the termination of the shareholder's entire interest also constitutes a qualifying disposition as described in § 1.1368-1(g)(2), the election under § 1.1368-1(g)(2) cannot be made. An S corporation may not make a terminating election if the cessation of a shareholder's interest occurs in a transaction which results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation. (See section 1362(e)(3) for an election to have items assigned to each short taxable year under normal tax accounting rules in the case of a termination of a corporation's election to be an S corporation.) A terminating election is irrevocable and is effective only for the terminating event for which it is made.

(2) *Effect of the terminating election—*  
(i) *In general.* An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for purposes of allocating items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account, earnings and profits, and basis; and determining the tax effect of a distribution to the shareholders. An S corporation that makes a terminating election must assign items of income (including tax-exempt income), loss, deduction, and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

(ii) *Due date of S corporation return.* A terminating election does not affect the due date of the S corporation's return required to be filed under section 6037(a) for a taxable year (determined without regard to a terminating election).

(iii) *Taxable year of inclusion by shareholder.* A terminating election does not affect the taxable year in which a shareholder (including any shareholder whose entire interest in the corporation has terminated during the