

corporation's taxable year) must take into account the shareholder's pro rata share of the S corporation's items of income, loss, deduction, and credit.

(iv) *S corporation that is a partner in a partnership.* 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) (relating to closing the partnership taxable year), if the taxable year of the partnership ends after the shareholder's interest is terminated and within the taxable year of the S corporation (determined without regard to any terminating election) for which the terminating election is made.

(3) *Determination of whether an S shareholder's entire interest has terminated.* For purposes of section 1377(a)(2) and paragraph (b) of this section, a shareholder's entire interest in an S corporation is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of any stock that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a shareholder's entire interest in an S corporation has been terminated, any options held by the shareholder (other than options that are treated as stock under § 1.1361-1(l)(4)(iii) and any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity are disregarded. (See § 1.1361-1(l)(4)(iii) for circumstances under which an option is treated as stock of the corporation and, therefore, the holder of the option is treated as owning a stock interest in the corporation.)

(4) *Time and manner of making terminating election—(i) In general.* An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return required to be filed under section 6037(a) (that is, a Form 1120S) for the taxable year during which a shareholder's entire interest is terminated. A single election statement

may be filed by the S corporation for all terminating elections for the taxable year. The election statement must include—

(A) A declaration by the S corporation that it is electing under section 1377(a)(2) and § 1.1377-1(b) to treat the taxable year as if it consisted of two separate taxable years;

(B) Information setting forth when and how the shareholder's entire interest was terminated (for example, a sale or gift);

(C) The signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury; and

(D) A notice of consent, signed by each person who is a shareholder in the S corporation during the taxable year (determined without regard to the terminating election), including any shareholder whose entire interest terminates during the taxable year, in which each shareholder consents to the S corporation making the terminating election.

(ii) *Shareholders required to consent.* For purposes of paragraph (b)(4)(i)(D) of this section, a shareholder of the S corporation for the taxable year is a shareholder as described in section 1362(a)(2). For example, the person who under § 1.1362-6(b)(2) must consent to a corporation's S election in certain special cases is the person who must consent to the terminating election. In addition, an executor or administrator of an estate of a deceased shareholder may consent to the terminating election on behalf of the deceased shareholder.

(iii) *More than one terminating election.* A shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to a terminating election made with respect to a subsequent termination within the same taxable year of the entire interest of another shareholder.

(c) *Examples.* The following examples illustrate the provisions of this section.

Example 1. General rule. (i) On January 2, 1997, X, a calendar year corporation, is incorporated. On January 4, 1997, X acquires assets. On January 6, 1997, X issues 100 shares of common stock to each of A and B and files an election to be an S corporation effective for its 1997 taxable year. During its 1997 taxable year, X has nonseparately computed income (as defined in section 1366(a)(2)) of \$720,000.

(ii) Each shareholder's pro rata share of X's nonseparately computed income for 1997 is determined by assigning an equal portion of the income to each day of X's taxable year on which X had shareholders. In the present case, there are only 360 days on which X had shareholders because X had no shareholders

until January 6, 1997. Thus, \$2,000 of nonseparately computed income is assigned to each day that X had shareholders ($\$720,000/360 \text{ days} = \$2,000 \text{ per day}$). The amount assigned to each day is multiplied by the percentage of shares held by the shareholder on that day. Because A and B each owned 50 percent of the shares of stock outstanding on each day that X had shareholders, each shareholder's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$2,000 \text{ per day} \times 50\%$). Finally, the amounts of each shareholder's daily pro rata shares are aggregated to produce the shareholder's pro rata share of X's nonseparately computed income for 1997. During 1997, A and B each held X stock for 360 days. Thus, each shareholder's pro rata share of X's nonseparately computed income for 1997 is \$360,000 ($\$1,000 \text{ per day} \times 360 \text{ days}$).

Example 2. Shareholder's pro rata share in the case of a partial disposition of stock. (i) X, a newly incorporated calendar year corporation, issues 100 shares of common stock on January 6, 1997, to each of A and B and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells 50 shares of X stock to C. Thus, in 1997, A owned 50 percent of the outstanding shares of X on each day of X's 1997 taxable year on which X had shareholders, B owned 50 percent on each day from January 6, 1997, to July 24, 1997 (200 days), and 25 percent from July 25, 1997, to December 31, 1997 (160 days), and C owned 25 percent from July 25, 1997, to December 31, 1997 (160 days).

(ii) Because B's entire interest in X is not terminated when B sells 50 shares to C on July 24, 1997, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section for B's sale of 50 shares to C. Although B's sale of 50 shares to C is a qualifying disposition under § 1.1368-1(g)(2)(i), X does not make an election to terminate its taxable year under § 1.1368-1(g)(2). During its 1997 taxable year, X has nonseparately computed income of \$720,000.

(iii) For each day in X's 1997 taxable year, A's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$720,000/360 \text{ days} \times 50\%$). Thus, A's pro rata share of X's nonseparately computed income for 1997 is \$360,000 ($\$1,000 \times 360 \text{ days}$). B's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$720,000/360 \times 50\%$) for the first 200 days of X's taxable year on which X has shareholders, and \$500 ($\$720,000/360 \times 25\%$) for the following 160 days in 1997. Thus, B's pro rata share of X's nonseparately computed income for 1997 is \$280,000 ($(\$1,000 \times 200 \text{ days}) + (\$500 \times 160 \text{ days})$). C's daily pro rata share of X's nonseparately computed income is \$500 ($\$720,000/360 \times 25\%$) for 160 days in 1997. Thus, C's pro rata share of X's nonseparately computed income for 1997 is \$80,000 ($\$500 \times 160 \text{ days}$).

Example 3. Shareholder's pro rata share when an S corporation makes a terminating election under section 1377(a)(2). (i) On January 6, 1997, X, a newly incorporated calendar year corporation, issues 100 shares of common stock to each of A and B and files an election to be treated as an S corporation for its 1997 taxable year. On July 24, 1997,