

B sells B's entire 100 shares of X corporation stock to C. During its 1997 taxable year, X has nonseparately computed income of \$720,000. X makes an election under section 1377(a)(2) and paragraph (b) of this section for the termination of B's entire interest arising from B's sale of 100 shares to C. As a result of the election, each shareholder's pro rata share is determined as if X's taxable year consisted of two separate taxable years, the first of which ends on July 24, 1997, the date B's entire interest in X terminates.

(ii) Under X's normal method of accounting, \$200,000 of the \$720,000 of nonseparately computed income is allocable to the period of January 6, 1997, through July 24, 1997 (the first deemed taxable year), and the remaining \$520,000 is allocable to the period of July 25, 1997, through December 31, 1997 (the second deemed taxable year).

(iii) The pro rata share of the \$200,000 of nonseparately computed income for each of A and B for the first deemed taxable year is determined by assigning the \$200,000 of nonseparately computed income to each day of the first deemed taxable year ($\$200,000/200 \text{ days}=\$1,000 \text{ per day}$). Thus, for each day of the first deemed taxable year, \$1,000 is allocated between A and B based on their proportionate stock ownership. Because A and B each held 50% of X's authorized and issued shares on each day of the first deemed taxable year, the daily pro rata share for each of A and B for each day of the first deemed taxable year is \$500 ($\$1,000 \text{ per day} \times 50\%$). Thus, each shareholder's pro rata share of the \$200,000 of nonseparately computed income for the first deemed taxable year is \$100,000 ($\$500 \text{ per day} \times 200 \text{ days}$). A and B must report these amounts for their respective taxable years with or within which X's full taxable year ends (December 31, 1997).

(iv) The pro rata share of the \$520,000 of nonseparately computed income for each of A and C for the second deemed taxable year is determined by assigning the \$520,000 of nonseparately computed income to each day of the second deemed taxable year ($\$520,000/160 \text{ days}=\$3,250 \text{ per day}$). Thus, for each day of the second deemed taxable year, \$3,250 is allocated between A and C based on their proportionate ownership. Because A and C each held 50% of X's authorized and issued shares on each day of the second deemed taxable year, the daily pro rata shares for each of A and C for each day of the second deemed taxable year is \$1,625 ($\$3,250 \text{ per day} \times 50\%$). Therefore, each shareholder's pro rata share of the \$520,000 nonseparately computed income is \$260,000 ($\$1,625 \text{ per day} \times 160 \text{ days}$). A and C must report these amounts for their respective taxable years with or within which X's full taxable year ends (December 31, 1997).

Example 4. Interaction between the terminating election under section 1377(a)(2) and section 1362(e). (i) On January 1, 1997, X, a calendar year S corporation, has two shareholders, A and B, owning 60 shares and 40 shares, respectively. On June 29, 1997, B sells B's 40 shares to C. On July 20, 1997, C sells C's 40 shares to P, a partnership, causing a termination under section 1362(d)(2) of X's election to be an S corporation. X makes an election under section 1377(a)(2) and paragraph (b) of this

section with regard to the termination of B's entire interest on June 29, 1997. Because the termination on July 20, 1997, of C's entire interest results in a termination of X's election to be an S corporation, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section with regard to C's sale of 40 shares to P. However, X makes an election under section 1362(e)(3) to assign items to each short taxable year of the S termination year under X's normal method of accounting. X has nonseparately computed income of \$530,000 for its 1997 taxable year.

(ii) As a result of the election under section 1362(e)(3), the portion of X's taxable year ending at the close of the day prior to the termination of X's S corporation election (January 1, 1997, through July 19, 1997) is treated as a short taxable year for which X is an S corporation, and the portion of the year beginning on the day the termination is effective (July 20, 1997, through December 31, 1997) is treated as a short taxable year for which X is a C corporation. Under X's normal method of accounting, \$200,000 of the \$530,000 of X's taxable income is allocable to the S short year and the remaining \$330,000 is allocable to the C short year. Of the \$200,000 allocable to the S short year, \$90,000 is allocable to the first deemed taxable year (January 1, 1997, through June 29, 1997) (180 days), and \$110,000 is allocable to the second deemed taxable year (June 30, 1997, through July 19, 1997) (20 days) under X's normal method of accounting.

(iii) Each shareholder's pro rata share of X's income for the first deemed taxable year within the S short year is determined as follows. Because A owns 60% of the stock outstanding during the first deemed taxable year, A's pro rata share for that period is \$54,000 ($\$90,000/180 \text{ days in the period} \times 60\% \times 180 \text{ days}$). B's pro rata share for that period, reflecting B's 40% ownership, is \$36,000 ($\$90,000/180 \text{ days in the period} \times 40\% \times 180 \text{ days}$). A and B must report these amounts for their respective taxable years with or within which the S termination year ends (December 31, 1997).

(iv) Each shareholder's pro rata share of X's income for the second deemed taxable year within the S short year is determined as follows. Because A owns 60% of the stock outstanding during the second deemed taxable year, A's pro rata share for that period is \$66,000 ($\$110,000/20 \text{ days in the period} \times 60\% \times 20 \text{ days}$). C's pro rata share for that period, reflecting C's 40% ownership, is \$44,000 ($\$110,000/20 \text{ days in the period} \times 40\% \times 20 \text{ days}$). A and C must report these amounts for their respective taxable years with or within which the S termination year ends (December 31, 1997).

§ 1.1377-2 Post-termination transition period.

(a) *In general.* For purposes of subchapter S of chapter 1 of the Code and this section, the term post-termination transition period 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—

(i) The day which is 1 year after such last day; or

(ii) 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.

(b) *When a post-termination transition period arises.* A post-termination transition period arises following the termination under section 1362(d) of a corporation's S election. For example, a post-termination transition period arises if a C corporation 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 post-termination transition period does not arise. (See § 1.1368-2(d)(2) for the treatment of the acquisition of the assets of an S corporation by another S corporation in a transaction to which section 381(a)(2) applies.) The special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period is available only to those shareholders who were shareholders in the S corporation at the time of the termination.

(c) *Last day of last taxable year.* For purposes of section 1377(b)(1)(A) and paragraph (a)(1) of this section, the last day of a corporation's last taxable year as an S corporation is—

(1) The last day of the short S taxable year under section 1362(e)(1)(A); or

(2) The date of transfer (within the meaning of section 381(a)(2)) in the event that a C corporation acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies.

(d) *Determination defined.* For purposes of section 1377(b)(1)(B) and paragraph (a)(2) of this section, the term determination means—

(1) A court decision rendered by a court of competent jurisdiction;

(2) A closing agreement entered into between the Secretary and the taxpayer pursuant to section 7121;

(3) A written agreement between the corporation and the Commissioner (including a statement acknowledging that the corporation's election to be an S corporation terminated under section 1362(d)) that the corporation failed to qualify as an S corporation;

(4) For a corporation subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A,