

shareholder must treat any gain recognized on a sale or exchange of S corporation stock as ordinary income to the extent of the shareholder's section 1254 costs with respect to the shares sold or exchanged.

The proposed regulations provide two exceptions to the general rule for determining the amount treated as ordinary income under section 1254 upon a sale or exchange of stock. The first exception is that the general rule does not apply to the extent that the shareholder establishes that the gain is not attributable to the section 1254 costs. The portion of the gain recognized that is not attributable to section 1254 costs is that portion of the gain recognized that exceeds the amount of ordinary income that the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) if, immediately prior to the sale or exchange of the stock, the corporation had sold at fair market value all of the corporation's property the disposition of which would result in the recognition by the shareholder of ordinary income under section 1254. To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs, the shareholder must attach to the shareholder's tax return a statement detailing the shareholder's share of the fair market value and basis, and the shareholder's section 1254 costs, for each of the S corporation's natural resource recapture properties held immediately before the sale or exchange of stock.

The second exception to the general rule for sales or exchanges of stock is that, in the case of a contribution of property to the S corporation prior to a stock sale or exchange pursuant to a plan a principal purpose of which is to avoid the recognition of ordinary income under section 1254, the selling or exchanging shareholder must recognize as ordinary income under section 1254 the amount of ordinary income the shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold all of its natural resource recapture property the disposition of which would result in ordinary income under section 1254. Section 1.1254-4(c)(3) *Example 3* of the proposed regulations illustrates this exception. The proposed regulations also provide rules for determining an S corporation shareholder's section 1254 costs. Generally, an S corporation shareholder's section 1254 costs with respect to any natural resource recapture property held by the corporation include all of the

shareholder's section 1254 costs with respect to the property while in the hands of the S corporation. In the case of a person (acquiring shareholder) who acquires stock from another shareholder, the proposed regulations provide that the acquiring shareholder's section 1254 costs are zero if the acquiring shareholder's basis for the stock transferred is determined by reference to its cost (within the meaning of section 1012) or by reference to the fair market value of the stock on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date). However, an acquiring shareholder's section 1254 costs include any section 1254 costs paid or incurred before the decedent's death, to the extent that the basis of the stock is reduced under section 1014(b)(9) (relating to adjustments to basis if the property is acquired from a decedent prior to death). For stock that is acquired in a transfer that is a gift, in a transfer that is part sale or exchange and part gift, or a transfer described in section 1041, the acquiring shareholder generally acquires the section 1254 costs of the transferor but reduces the section 1254 costs by the amount of any gain treated as ordinary income under section 1254 by the transferor on the transfer.

The proposed regulations provide rules for applying section 1254 to the shareholders of an S corporation that incurred section 1254 costs while it was a C corporation (former C corporation). In the case of a C corporation that holds natural resource recapture property and that elects to be an S corporation, each shareholder's section 1254 costs as of the beginning of the corporation's first taxable year as an S corporation include a *pro rata* share of the section 1254 costs of the corporation as of the close of the last taxable year that the corporation was a C corporation.

The proposed regulations also provide rules for applying section 1254 to a corporation that holds natural resource recapture property after the termination of its S corporation election (former S corporation). In the case of an S corporation that becomes a C corporation, the C corporation's section 1254 costs with respect to any natural resource recapture property held by the corporation as of the beginning of the corporation's first taxable year as a C corporation include the sum of its shareholders' section 1254 costs with respect to the property as of the close of the last taxable year for which the corporation was an S corporation. In the case of an S termination year as defined in section 1362(e)(4), the shareholders'

section 1254 costs are determined as of the close of the S short year as defined in section 1362(e)(1)(A).

Because certain transactions will change the allocation to the shareholders of gain or amount realized from the natural resource recapture property if the S corporation disposes of it subsequent to these transactions, the proposed regulations require that section 1254 costs be reallocated to reflect the effects of these transactions. Transactions requiring reallocation of the section 1254 costs are transactions involving the issuance of stock by an S corporation in a reorganization or otherwise, and transfers of natural resource recapture property to the S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction or in a reorganization).

The rules for former S corporations and the rules for allocating section 1254 costs upon certain transfers require the S corporation to determine the aggregate of its shareholders' section 1254 costs. The proposed regulations provide rules for the S corporation to apply in determining a shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation. In general, the S corporation may determine a shareholder's section 1254 costs by using written data provided by the shareholder or by applying certain assumptions.

These regulations are proposed to apply to dispositions of natural resource recapture property by an S corporation (and a former S corporation) and dispositions of S corporation stock occurring after publication of these regulations as final regulations in the Federal Register.

Comments and Requests for a Public Hearing

Before the adoption of these proposed regulations, consideration will be given to any written comments that are timely submitted (preferably an original and eight copies) to the IRS. All comments will be available for public inspection and copying. A public hearing will be held upon written request to the Internal Revenue Service by any person who also submits written comments. If a public hearing is held, notice of the time and place will be published in the Federal Register.

Special Analyses

It has been determined that this proposed regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section