

(B) *Substantiation.* To establish that a portion of the gain recognized is not attributable to a shareholder's section 1254 costs so as to qualify for the exception contained in paragraph (c)(2)(i)(A) of this section, 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.

(ii) *Transactions entered into as part of a plan to avoid recognition of ordinary income under section 1254.* In the case of a contribution of property prior to a sale or exchange of stock pursuant to a plan a principal purpose of which is to avoid recognition of ordinary income under section 1254, paragraph (c)(1) of this section does not apply. Instead, the amount recognized as ordinary income under section 1254 is the amount of ordinary income the selling or exchanging shareholder would have recognized under section 1254 (with respect to the shares sold or exchanged) had the S corporation sold its natural resource recapture property the disposition of which would have resulted in the recognition of ordinary income under section 1254. The amount recognized as ordinary income under the preceding sentence reduces the amount realized on the sale or exchange of the stock. This reduced amount realized is used in determining any gain or loss on the sale or exchange.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (c):

*Example 1. Application of general rule upon a sale of S corporation stock.* C and D are equal shareholders in Y, an S corporation. As of January 1, 1995, Y holds two mining properties: Blackacre, with an adjusted basis of \$5,000 and a fair market value of \$35,000, and Whiteacre, with an adjusted basis of \$20,000 and a fair market value of \$15,000. Y also holds securities with a basis of \$5,000 and a fair market value of \$10,000. On January 1, 1995, D sells 50 percent of D's Y stock to E for \$15,000. As of the date of the sale, D's adjusted basis in the Y stock sold is \$7,500, and D has \$18,000 of section 1254 costs with respect to Blackacre and \$12,000 of section 1254 costs with respect to Whiteacre. Under this paragraph (c), the gain recognized by D upon the sale of Y stock is treated as ordinary income to the extent of D's section 1254 costs with respect to the stock sold, unless D establishes that a portion of such excess is not attributable to D's section 1254 costs. However, because D would recognize \$7,500 in ordinary income under section 1254 with respect to the stock sold if Y sold Blackacre (the only asset the disposition of which would result in

ordinary income to D under section 1254), the \$7,500 of gain recognized by D upon the sale of D's Y stock is attributable to D's section 1254 costs. Therefore, upon the sale of stock to E, D recognizes \$7,500 of ordinary income under this paragraph (c).

*Example 2. Sale of S corporation stock where gain is not entirely attributable to section 1254 costs.* Assume the same facts as in *Example 1*, except that Blackacre has a fair market value of \$25,000, and the securities have a fair market value of \$20,000. Immediately prior to the sale of stock to E, if Y had sold Blackacre (its only asset the disposition of which would result in the recognition of ordinary income to D under section 1254), D would recognize \$5,000 in ordinary income with respect to the stock sold under section 1254. D attaches a statement to D's tax return for 1995 detailing D's share of the fair market values and bases, and D's section 1254 costs with respect to Blackacre and Whiteacre. Therefore, upon the sale of stock to E, of the \$7,500 gain recognized by D, \$5,000 is ordinary income under this paragraph (c).

*Example 3. Contribution of property prior to sale of S corporation stock as part of a plan to avoid recognition of ordinary income under section 1254.* H owns all of the stock of Z, an S corporation. As of January 1, 1995, H has \$3,000 of section 1254 costs with respect to property P, which is natural resource recapture property and Z's only asset. Property P has an adjusted basis of \$5,000 and a fair market value of \$8,000. H has a basis of \$5,000 in Z stock, which has a fair market value of \$8,000. On January 1, 1995, H contributes securities to Z which have a basis of \$7,000 and a fair market value of \$4,000. On April 15, 1995, H sells all of the Z stock to J for \$12,000. On that date, H's adjusted basis in the Z stock is also \$12,000. Based on all the facts and circumstances, the sale of stock is part of a plan (along with the contribution by H of the securities to Z) that has a principal purpose to avoid recognition of ordinary income under section 1254. Consequently, under paragraph (c)(2)(ii) of this section, H must recognize \$3,000 as ordinary income under section 1254, the amount of ordinary income that H would recognize as ordinary income under section 1254 if property P were sold at fair market value. In addition, H reduces the amount realized on the sale of the stock (\$12,000) by \$3,000. As a result, H also recognizes a \$3,000 capital loss on the sale of the stock (\$9,000 amount realized less \$12,000 adjusted basis).

(d) *Section 1254 costs of a shareholder.* 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 in the hands of the S corporation. See § 1.1254-1(b)(1) for the definition of section 1254 costs.

(e) *Section 1254 costs of an acquiring shareholder after certain acquisitions—*(1) *Basis determined under section 1012.* If stock in an S corporation that

holds natural resource recapture property is acquired and the acquiring shareholder's basis for the stock is determined solely by reference to its cost (within the meaning of section 1012), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(2) *Basis determined by reason of the application of section 1014(a).* If stock in an S corporation that holds natural resource recapture property is acquired from a decedent and the acquiring shareholder's basis is determined, by reason of the application of section 1014(a), solely 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), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands is zero on the acquisition date.

(3) *Basis determined by reason of the application of section 1014(b)(9).* If stock in an S corporation that holds natural resource recapture property is acquired before the death of the decedent, the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands includes the amount, if any, of the section 1254 costs deducted by the acquiring shareholder before the decedent's death, to the extent that the basis of the stock (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is acquired before the death of the decedent).

(4) *Gifts and section 1041 transfers.* If stock is acquired in a transfer that is a gift, in a transfer that is a part sale or exchange and part gift, or in a transfer that is described in section 1041(a), the amount of section 1254 costs with respect to the property held by the corporation in the acquiring shareholder's hands immediately after the transfer is an amount equal to—

(i) The amount of section 1254 costs with respect to the property held by the corporation in the hands of the transferor immediately before the transfer; minus

(ii) The amount of any gain recognized as ordinary income under section 1254 by the transferor upon the transfer.

(f) *Special rules for former S corporations and former C corporations—*(1) *Section 1254 costs of an S corporation that was formerly a C corporation.* In the case of a C