

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.

(2) *Examples.* The following examples illustrate the application of the provisions of paragraph (f)(1) of this section:

Example 1. Sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i) Y is a C corporation that elects to be an S corporation effective January 1, 1996. On that date, Y owns Oil Well, which is natural resource recapture property and a capital asset. Y has section 1254 costs of \$20,000 as of the close of the last taxable year that it was a C corporation. On January 1, 1996, Oil Well has a value of \$200,000 and a basis of \$100,000. Thus, under section 1374, Y's net unrealized built-in gain is \$100,000. Also on that date, Y's basis in Oil Well is allocated to A, Y's sole shareholder, under section 613A(c)(11) and the section 1254 costs are allocated to A under § 1.1254-4(f)(1). In addition, A has a basis in A's Y stock of \$100,000.

(ii) On November 1, 1996, Y sells Oil Well for \$250,000. During 1996, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain. Consequently, A recognizes ordinary income of \$20,000 and net capital gain of \$95,000 (\$130,000 minus \$35,000) on the sale.

Example 2. Sale of stock followed by sale of natural resource recapture property held by an S corporation that was formerly a C corporation—(i) Assume the same facts as in *Example 1*(i). On November 1, 1996, A sells all of A's Y stock to P for \$250,000. A has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000) of which \$20,000 is recognized as ordinary income under section 1254, and \$130,000 is recognized as capital gain.

(ii) On November 2, 1996, Y sells Oil Well for \$250,000. During 1996, Y has taxable income greater than \$100,000, and no other transactions or items treated as recognized built-in gain or loss. Under section 1374, Y has net recognized built-in gain of \$100,000. Assuming a tax rate of 35 percent on capital gain, Y has a tax of \$35,000 under section 1374. The tax of \$35,000 is treated as a capital loss under section 1366(f)(2). P has a realized gain on the sale of \$150,000 (\$250,000 minus \$100,000), which is

recognized as capital gain. Consequently, P recognizes net capital gain of \$115,000 (\$150,000 minus \$35,000) on the sale.

(3) *Section 1254 costs of a C corporation that was formerly an 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 that 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). See paragraph (g)(5) of this section for rules on determining the aggregate amount of the shareholders' section 1254 costs.

(g) *Determination of a shareholder's section 1254 costs upon certain stock transactions—*(1) *Issuance of stock.* Upon an issuance of stock (whether such stock is newly-issued or had been held as treasury stock) by an S corporation in a reorganization or otherwise—

(i) Each recipient of shares must be allocated a *pro rata* share (determined solely with respect to the shares issued in the transaction) of the aggregate of the S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance (as determined pursuant to paragraph (g)(5) of this section); and

(ii) Each pre-existing shareholder must reduce his or her section 1254 costs with respect to natural resource recapture property held by the S corporation immediately before the issuance by an amount equal to the pre-existing shareholder's section 1254 costs multiplied by the percentage of stock of the corporation issued in the transaction.

(2) *Natural resource recapture property acquired in exchange for stock.* If natural resource recapture property is transferred to an S corporation in exchange for stock of the S corporation (for example, in a section 351 transaction, or in a reorganization described in section 368), the S corporation must allocate to its shareholders a *pro rata* share of the S corporation's section 1254 costs with respect to the property immediately after the transaction (as determined under § 1.1254-3(b)(1)).

(3) *Treatment of nonvested stock.* Stock issued in connection with the performance of services that is substantially nonvested (within the meaning of § 1.83-3(b)) is treated as issued for purposes of this section at the first time it is treated as outstanding stock of the S corporation for purposes of section 1361.

(4) *Exception.* Paragraph (g)(1) of this section does not apply to stock issued in exchange for stock of the same S corporation (as for example, in a recapitalization described in section 368(a)(1)(E)).

(5) *Aggregate of S corporation shareholders' section 1254 costs with respect to natural resource recapture property held by the S corporation—*(i) *In general.* The aggregate of S corporation shareholders' section 1254 costs is equal to the sum of each shareholder's section 1254 costs. The S corporation must determine each shareholder's section 1254 costs under either paragraph (g)(5)(i)(A) (written data) or paragraph (g)(5)(i)(B) (assumptions) of this section. The S corporation may determine the section 1254 costs of some shareholders under paragraph (g)(5)(i)(A) of this section and of others under paragraph (g)(5)(i)(B) of this section.

(A) *Written data.* An S corporation may determine a shareholder's section 1254 costs by using written data provided by a shareholder showing the shareholder's section 1254 costs with respect to natural resource recapture property held by the S corporation unless the S corporation knows or has reason to know that the written data is inaccurate. If an S corporation does not receive written data upon which it may rely, the S corporation must use the assumptions provided in paragraph (g)(5)(i)(B) of this section in determining a shareholder's section 1254 costs.

(B) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(i)(A) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs.

(1) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(2) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate