

**Internal Revenue Service, Treasury**

**§ 1.1374-4**

[\$5,000×(\$9,600/\$20,000)=\$2,400]. Under paragraph (c) of this section, X has a recognized built-in gain carryover to 1997 of \$10,400 (\$20,000−\$9,600=\$10,400), consisting of \$7,800 (\$15,000−\$7,200=\$7,800) of recognized built-in ordinary income and \$2,600 (\$5,000−\$2,400=\$2,600) of recognized built-in capital gain.

[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

**§ 1.1374-3 Net unrealized built-in gain.**

(a) *In general.* An S corporation's net unrealized built-in gain is the total of the following—

(1) The amount that would be the amount realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at fair market value to an unrelated party that assumed all its liabilities; decreased by

(2) Any liability of the corporation that would be included in the amount realized on the sale referred to in paragraph (a)(1) of this section, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

(3) The aggregate adjusted bases of the corporation's assets at the time of the sale referred to in paragraph (a)(1) of this section; increased or decreased by

(4) The corporation's section 481 adjustments that would be taken into account on the sale referred to in paragraph (a)(1) of this section; and increased by

(5) Any recognized built-in loss that would not be allowed as a deduction under section 382, 383, or 384 on the sale referred to in paragraph (a)(1) of this section.

(b) *Example.* The rules of this section are illustrated by the following example.

*Example: Net unrealized built-in gain.* (i) (a) X, a calendar year C corporation using the cash method, elects to become an S corporation on January 1, 1996. On December 31, 1995, X has assets and liabilities as follows:

Assets	FMV	Basis
Factory .....	\$500,000	\$900,000
Accounts Receivable .....	300,000	0
Goodwill .....	250,000	0
<b>Total .....</b>	<b>1,050,000</b>	<b>900,000</b>
<b>Liabilities</b>	<b>Amount</b>	
Mortgage .....	\$200,000	

Assets	FMV	Basis
Accounts Payable .....	100,000	
<b>Total .....</b>	<b>300,000</b>	

(b) Further, X must include a total of \$60,000 in taxable income in 1996, 1997, and 1998 under section 481(a).

(ii) If, on December 31, 1995, X sold all its assets to a third party that assumed all its liabilities, X's amount realized would be \$1,050,000 (\$750,000 cash received+\$300,000 liabilities assumed=\$1,050,000). Thus, X's net unrealized built-in gain is determined as follows:

Amount realized — .....	\$1,050,000
Deduction allowed— .....	(100,000)
Basis of X's assets— .....	(900,000)
Section 481 adjustments .....	60,000
<b>Net unrealized built-in gain— .....</b>	<b>110,000</b>

[T.D. 8579, 59 FR 66464, Dec. 27, 1994]

**§ 1.1374-4 Recognized built-in gain or loss.**

(a) *Sales and exchanges—(1) In general.* Section 1374(d)(3) or 1374(d)(4) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for Federal income tax purposes.

(2) *Oil and gas property.* For purposes of paragraph (a)(1) of this section, an S corporation's adjusted basis in oil and gas property equals the sum of the shareholders' adjusted bases in the property as determined in section 613A(c)(11)(B).

(3) *Examples.* The rules of this paragraph (a) are illustrated by the following examples.

*Example 1. Production and sale of oil.* X is a C corporation that purchased a working interest in an oil and gas property for \$100,000 on July 1, 1993. X elects to become an S corporation effective January 1, 1996. On that date, the working interest has a fair market value of \$250,000 and an adjusted basis of \$50,000, but no oil has as yet been extracted. In 1996, X begins production of the working interest, sells oil that it has produced to a refinery for \$75,000, and includes that amount in gross income. Under paragraph (a)(1) of this section, the \$75,000 is not recognized built-in gain because as of the beginning of the recognition period X held only a working interest in the oil and gas property (since the oil had not yet been extracted from the ground), and not the oil itself.

*Example 2. Sale of oil and gas property.* Y is a C corporation that elects to become an S corporation effective January 1, 1996. Y has two shareholders, A and B. A and B each own