

Internal Revenue Service, Treasury

§ 1.1368-1

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[T.D. 8508, 59 FR 18, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996; T.D. 8852, 64 FR 71649, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368-1 Distributions by S corporations.

(a) *In general.* This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.

(b) *Date distribution made.* For purposes of section 1368, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.

(c) *S corporation with no earnings and profits.* A distribution made by an S corporation that has no accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(b).

(d) *S corporation with earnings and profits—(1) General treatment of distribution.* Except as provided in paragraph (d)(2) of this section, a distribution made with respect to its stock by an S corporation that has accumulated earnings and profits as of the end of the taxable year of the S corporation in which the distribution is made is treated in the manner provided in section 1368(c). See section 316 and § 1.316-2 for provisions relating to the allocation of earnings and profits among distributions.

(2) *Previously taxed income.* This paragraph (d)(2) applies to distributions by a corporation that has both accumulated earnings and profits and previously taxed income (within the meaning of section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982, and the regulations thereunder) with respect to one or more shareholders. In the case of such a distribution, that portion remaining after the application of section 1368(c)(1) (relating to distributions from the accumulated adjustments account (AAA) as defined in § 1.1368-2(a)) is treated in the manner provided in section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a

distribution of money and does not exceed the shareholder's net share immediately before the distribution of the corporation's previously taxed income. The AAA and the earnings and profits of the corporation are not decreased by that portion of the distribution. Any distribution remaining after the application of this paragraph (d)(2) is treated in the manner provided in section 1368(c) (2) and (3).

(e) *Certain adjustments taken into account*—(1) *Taxable years beginning before January 1, 1997.* For any taxable year of the corporation beginning before January 1, 1997, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367 (without regard to section 1367(a)(2)(A) (relating to decreases attributable to distributions not includible in income)) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under § 1.1368-2(a)(3)(iii)) for the S corporation's taxable year.

(2) *Taxable years beginning on or after August 18, 1998.* For any taxable year of the corporation beginning on or after August 18, 1998, paragraphs (c) and (d) of this section are applied only after taking into account—

(i) The adjustments to the basis of the shares of a shareholder's stock described in section 1367(a)(1) (relating to increases in basis of stock) for the S corporation's taxable year; and

(ii) The adjustments to the AAA required by section 1368(e)(1)(A) (but without regard to the adjustments for distributions under § 1.1368-2(a)(3)(iii)) for the S corporation's taxable year. Any net negative adjustment (as defined in section 1368(e)(1)(C)(ii)) for the taxable year shall not be taken into account.

(f) *Elections relating to source of distributions*—(1) *In general.* An S corporation may modify the application of paragraphs (c) and (d) of this section by electing (pursuant to paragraph (f)(5) of this section)—

(i) To distribute earnings and profits first as described in paragraph (f)(2) of this section;

(ii) To make a deemed dividend as described in paragraph (f)(3) of this section; or

(iii) To forego previously taxed income as described in paragraph (f)(4) of this section.

(2) *Election to distribute earnings and profits first*—(i) *In general.* An S corporation with accumulated earnings and profits may elect under this paragraph (f)(2) for any taxable year to distribute earnings and profits first as provided in section 1368(e)(3). Except as provided in paragraph (f)(2)(ii) of this section, distributions made by an S corporation making this election are treated as made first from earnings and profits under section 1368(c)(2) and second from the AAA under section 1368(c)(1). Any remaining portion of the distribution is treated in the manner provided in section 1368(b). This election is effective for all distributions made during the year for which the election is made.

(ii) *Previously taxed income.* If a corporation to which paragraph (d)(2) of this section (relating to corporations with previously taxed income) applies makes the election provided in this paragraph (f)(2) for the taxable year, and does not make the election to forego previously taxed income under paragraph (f)(4) of this section, distributions by the S corporation during the taxable year are treated as made first, from previously taxed income under paragraph (d)(2) of this section; second, from earnings and profits under section 1368(c)(2); and third, from the AAA under section 1368(c)(1). Any portion of a distribution remaining after the previously taxed income, earnings and profits, and the AAA are exhausted is treated in the manner provided in section 1368(b).

(iii) *Corporation with subchapter C and subchapter S earnings and profits.* If an S corporation that makes the election provided in this paragraph (f)(2) has both subchapter C earnings and profits (as defined in section 1362(d)(3)(B)) and subchapter S earnings and profits in a taxable year of the corporation in which the distribution is made, the distribution is treated as made first from subchapter C earnings and profits, and second from subchapter S earnings and

profits. *Subchapter S earnings and profits* are earnings and profits accumulated in a taxable year beginning before January 1, 1983 (or in the case of a qualified casualty insurance electing small business corporation or a qualified oil corporation, earnings and profits accumulated in any taxable year), for which an election under subchapter S of chapter 1 of the Internal Revenue Code was in effect.

(3) *Election to make a deemed dividend.* An S corporation may elect under this paragraph (f)(3) to distribute all or part of its subchapter C earnings and profits through a deemed dividend. If an S corporation makes the election provided in this paragraph (f)(3), the S corporation will be considered to have made the election provided in paragraph (f)(2) of this section (relating to the election to distribute earnings and profits first). The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. The amount of the deemed dividend is considered, for all purposes of the Internal Revenue Code, as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

(4) *Election to forego previously taxed income.* An S corporation may elect to forego distributions of previously taxed income. If such an election is made, paragraph (d)(2) of this section (relating to corporations with previously taxed income) does not apply to any distribution made during the taxable year. Thus, distributions by a corporation that makes the election to forego previously taxed income for a taxable year under this paragraph (f)(4) and does not make the election to distribute earnings and profits first under paragraph (f)(2) of this section are treated in the manner provided in section 1368(c) (relating to distributions by corporations with earnings and profits). Distributions by a corporation that makes both the election to dis-

tribute earnings and profits first under paragraph (f)(2) of this section and the election to forego previously taxed income under this paragraph (f)(4), are treated in the manner provided in paragraph (f)(2)(i) of this section.

(5) *Time and manner of making elections—(i) For earnings and profits.* If an election is made under paragraph (f)(2) of this section to distribute earnings and profits first, see section 1368(e)(3) regarding the consent required by shareholders.

(ii) *For previously taxed income and deemed dividends.* If an election is made to forego previously taxed income under paragraph (f)(4) of this section or to make a deemed dividend under paragraph (f)(3) of this section, consent by each "affected shareholder," as defined in section 1368(e)(3)(B), is required.

(iii) *Corporate statement regarding elections.* A corporation makes an election for a taxable year under § 1.1368-1(f) by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under section 6037 for that taxable year. In the statement, the corporation must identify the election it is making under § 1.1368-1(f) and must state that each shareholder consents to the election. In the case of elections for taxable years beginning before January 1, 2003, an officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. In the case of elections for taxable years beginning after December 31, 2002, the statement described in this paragraph (f)(5)(iii) shall be verified by signing the return. A statement of election to make a deemed dividend under § 1.1368-1(f) must include the amount of the deemed dividend that is distributed to each shareholder.

(iv) *Irrevocable elections.* The elections under this paragraph (f) are irrevocable and are effective only for the taxable year for which they are made. In applying the preceding sentence to elections under this paragraph (f), an election to terminate the taxable year under section 1377(a)(2) or § 1.1368-1(g)(2) is disregarded.

(g) *Special rule—(1) Election to terminate year under § 1.1368-1(g)(2).* If an election is made under paragraph (g)(2) of this section to terminate the year

when there is a qualifying disposition, this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which there is a qualifying disposition of stock.

(2) *Election in case of a qualifying disposition*—(i) *In general.* In the case of a qualifying disposition, a corporation may elect under this paragraph (g)(2)(i) to treat the year as if it consisted of separate taxable years, the first of which ends at the close of the day on which the qualifying disposition occurs. A *qualifying disposition* is—

(A) A disposition by a shareholder of 20 percent or more of the outstanding stock of the corporation in one or more transactions during any thirty-day period during the corporation's taxable year;

(B) A redemption treated as an exchange under section 302(a) or section 303(a) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any thirty-day period during the corporation's taxable year; or

(C) An issuance of an amount of stock equal to or greater than 25 percent of the previously outstanding stock to one or more new shareholders during any thirty-day period during the corporation's taxable year.

(ii) *Effect of the election.* A corporation making an election under paragraph (g)(2)(i) of this section must treat the taxable year as separate taxable years for purposes of allocating items of income and loss; making adjustments to the AAA, earnings and profits, and basis; and determining the tax effect of distributions under section 1368 (b) and (c). An election made under paragraph (g)(2)(i) of this section may be made upon the occurrence of any qualifying disposition. Dispositions of stock that are taken into account as part of a qualifying disposition are not taken into account in determining whether a subsequent qualifying disposition has been made. In the case of a taxable year for which an election is made under paragraph (g)(2)(i), for purposes of section 163(j), a separate section 163(j) limitation (as defined in § 1.163(j)-1(b)(36)) applies to each separate taxable year. Any items

necessary to determine the amount of business interest expense (as defined in § 1.163(j)-1(b)(3)) that are deducted in each separate taxable year must be allocated between the two separate taxable years in accordance with an allocation methodology provided in this paragraph (g).

(iii) *Time and manner of making election.* A corporation makes an election under § 1.1368-1(g)(2)(i) for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under section 6037 for a taxable year (without regard to the election under § 1.1368-1(g)(2)(i)). In the statement, the corporation must state that it is electing for the taxable year under § 1.1368-1(g)(2)(i) to treat the taxable year as if it consisted of separate taxable years. The corporation also must set forth facts in the statement relating to the qualifying disposition (*e.g.*, sale, gift, stock issuance, or redemption), and state that each shareholder who held stock in the corporation during the taxable year (without regard to the election under § 1.1368-1(g)(2)(i)) consents to this election. For purposes of this election, a shareholder of the corporation for the taxable year is a shareholder as described in section 1362(a)(2). A single election statement may be filed for all elections made under § 1.1368-1(g)(2)(i) for the taxable year. An election made under § 1.1368-1(g)(2)(i) is irrevocable. In the case of elections for taxable years beginning before January 1, 2003, the statement through which a corporation makes an election under § 1.1368-1(g)(2)(i) must be signed by an officer of the corporation under penalties of perjury. In the case of elections for taxable years beginning after December 31, 2002, the statement described in the preceding sentence shall be verified by signing the return.

(iv) *Coordination with election under section 1377(a)(2).* If the event resulting in a qualifying disposition also results in a termination of a shareholder's entire interest as described in § 1.1377-1(b)(4), the election under this paragraph (g)(2) cannot be made. Rather, the election under section 1377(a)(2) and § 1.1377-1(b) may be made. See

§ 1.1377-1(b) (concerning the election under section 1377(a)(2)).

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§ 1.1368-2 Accumulated adjustments account (AAA).

(a) *Accumulated adjustments account—*

(1) *In general.* The accumulated adjustments account is an account of the S corporation and is not apportioned among shareholders. The AAA is relevant for all taxable years beginning on or after January 1, 1983, for which the corporation is an S corporation. On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero. The AAA is increased in the manner provided in paragraph (a)(2) of this section and is decreased in the manner provided in paragraph (a)(3) of this section. For the adjustments to the AAA in the case of redemptions, liquidations, reorganizations, and corporate separations, see paragraph (d) of this section.

(2) *Increases to the AAA.* The AAA is increased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year:

(i) The items of income described in section 1366(a)(1)(A) other than income that is exempt from tax;

(ii) Any nonseparately computed income determined under section 1366(a)(1)(B); and

(iii) The excess of the deductions for depletion over the basis of property subject to depletion unless the property is an oil or gas property the basis of which has been allocated to shareholders under section 613A(c)(11).

(3) *Decreases to the AAA—*(i) *In general.* The AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year—

(A) The items of loss or deduction described in section 1366(a)(1)(A);

(B) Any nonseparately computed loss determined under section 1366(a)(1)(B);

(C) Any expense of the corporation not deductible in computing its taxable

income and not properly chargeable to a capital account, other than—

(1) Federal taxes attributable to any taxable year in which the corporation was a C corporation; and

(2) Expenses related to income that is exempt from tax; and

(D) The sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation described in section 1367(a)(2)(E).

(ii) *Extent of allowable reduction.* The AAA may be decreased under paragraph (a)(3)(i) of this section below zero. The AAA is decreased by noncapital, nondeductible expenses under paragraph (a)(3)(i)(C) of this section even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under § 1.1367-1(g) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under section 1366(d)(1) or is otherwise not currently deductible under the Internal Revenue Code. However, in any subsequent taxable year in which the loss, deduction, or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or § 1.1367-1(g) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

(iii) *Decrease to the AAA for distributions.* The AAA is decreased (but not below zero) by any portion of a distribution to which section 1368 (b) or (c)(1) applies.

(4) *Ordering rules for the AAA for taxable years beginning before January 1, 1997.* For any taxable year beginning before January 1, 1997, the adjustments to the AAA are made in the following order—

(i) The AAA is increased under paragraph (a)(2) of this section before it is decreased under paragraph (a)(3) of this section for the taxable year;

(ii) The AAA is decreased under paragraph (a)(3)(i) of this section before it is decreased under paragraph (a)(3) (iii) of this section;