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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8508]
RIN 1545-AE26

Adjustments to Basis of Stock and Indebtedness to Shareholders of
S Corporations and Treatment of Distributions by S Corporations to
Shareholders

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1367 of the Internal Revenue Code relating to adjustments to the basis of a shareholder's stock in an S corporation and the basis of indebtedness of an S corporation to a shareholder. This document also contains final regulations under section 1368 of the Internal Revenue Code relating to the treatment of distributions by an S corporation to its shareholders. Changes to the applicable law were made by the Subchapter S Revision Act of 1982, the Technical Corrections Act of 1982, the Tax Reform Act of 1984, and the Tax Reform Act of 1986. The final regulations affect S corporations and their shareholders and are necessary to provide them with the guidance they need to comply with the applicable tax law.

EFFECTIVE DATE: These regulations are effective on January 1, 1994 and apply to taxable years beginning on and after January 1, 1994.

FOR FURTHER INFORMATION CONTACT: Deane M. Burke (202) 622-3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1139. The estimated annual burden per respondent varies from .05 to .2 hour, depending on individual circumstances, with an estimated average of .1 hour.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document amends 26 CFR part 1 that provides rules under sections 1367 and 1368 of the Internal Revenue Code of 1986 (Code), as

amended. The amendments conform the regulations to amendments made to sections 1367 and 1368 by sections 2 and 6 of the Subchapter S Revision Act of 1982, section 305 of the Technical Corrections Act of 1982, sections 721(d), (r), and (w) and 722(e)(2) of the Tax Reform Act of 1984, and section 1879(m)(1)(B) of the Tax Reform Act of 1986.

On June 9, 1992, the Federal Register published a notice of proposed rulemaking (57 FR 24426) (the proposed regulations) concerning adjustments to basis of stock and indebtedness to shareholders of S corporations and treatment of distributions by S corporations to shareholders. Because no one requested to testify, the Service cancelled a public hearing scheduled for September 14, 1992. The Service, however, received written comments on the proposed regulations. After consideration of all of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

The final regulations provide rules under section 1367 regarding adjustments to the basis of a shareholder's stock in an S corporation and the basis of indebtedness of an S corporation to a shareholder. The final regulations also provide rules under section 1368 regarding the treatment of distributions by an S corporation to its shareholders. Except for modifications in response to the comments, which were generally favorable, these final regulations generally provide the same rules as the proposed regulations.

I. Adjustments to Basis of Stock

A. Separate Basis Approach

The proposed regulations provided a separate basis approach (comparable to the basis of a shareholder in C corporation stock) for determining adjustments to the basis of a shareholder's stock in an S corporation. The proposed regulations also provided a spillover rule that allowed a shareholder to apply losses and deductions in excess of the basis of a share of stock to which such items are attributable against the remaining bases of all other shares of stock owned by a shareholder. The Service invited and received comments on whether another approach such as an aggregate/average basis (comparable to the basis of a partner in a partnership interest) should be used for purposes of sections 1367, 1368, and 1012.

Commentators generally favored the separate basis approach with the spillover rule in the proposed regulations. The final regulations therefore retain this rule. In response to comments, the final regulations clarify that the spillover rule applies to basis adjustments for distributions to shareholders as well as to adjustments for pro rata shares of passthrough items of losses or deductions.

B. Ordering Rule

Under the proposed regulations, adjustments are made to the basis of a share of stock in the following order: (1) increases for income items (including tax-exempt income) and The excess of deductions for depletion over basis for non-oil and gas properties; (2) decreases for noncapital, nondeductible expenses and certain oil and gas depletion deductions; (3) decreases for items of loss or deduction; and (4) decreases for distributions. The Service invited and received several comments regarding the ordering rules.

Some commentators suggested that decreases to basis for distributions should occur prior to decreases for any losses or deductions, noncapital, nondeductible expenses, and oil and gas depletion deductions. The legislative history on this issue is contradictory. On the one hand, the committee reports state that the S corporation rules for adjusting basis generally will be analogous to those provided for partnerships (which adjust basis first for distributions, then for losses and deductions). On the other hand, the reports also state that "income and loss for any corporate taxable year will apply to adjust basis before the distribution rules apply for that year." See H.R. Rep. No. 826, 97th Cong., 2d Sess. 17 (1982); S. Rep. No. 640, 97th Cong., 2d Sess. 18 (1982). The language of the loss limitation rule of section 1366(d)(1) suggests that losses are to be applied against basis prior to distributions. Section 1366(d)(1) provides that "[t]he aggregate amount of losses and deductions taken into account by a shareholder * * * for a taxable year shall not exceed the sum of (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to [increases for income and depletion items]), and (B) the shareholder's adjusted basis in any debt of the S corporation * * * ." Because of the specific statement in the legislative history, and the implication in section 1366(d)(1), the Service and the Treasury Department believe that it is appropriate to require adjustments for losses and deductions prior to adjustments for distributions. Thus, the final regulations retain the ordering rule of the proposed regulations.

Commentators also suggested that decreases to basis for items of loss or deduction should occur prior to decreases for noncapital, nondeductible expenses and oil and gas depletion deductions. In response to the comments, the final regulations provide that decreases for items of loss or deduction may precede decreases for noncapital, nondeductible expenses and oil and gas depletion deductions if a shareholder agrees that noncapital, nondeductible expenses in excess of basis and certain oil and gas depletion deductions will reduce basis in succeeding taxable years.

II. Adjustments to Debt Basis and Open Account Debt

The Service invited comments regarding the proper treatment of open account debt (advances to an S corporation by a shareholder that are not represented by separate written instruments and that are typically treated as one account by the S corporation) for purposes of reducing and restoring basis in indebtedness. In particular, the Service asked for comments on whether it is appropriate to treat each advance as a separate debt or all advances as a single debt. Several commentators suggested that the final regulations should provide a rule treating open account debt as a single debt for all advances by a shareholder. In response to comments, and for reasons of administrative simplicity, the final regulations provide that all open account debt held by a shareholder is to be treated as a single debt for purposes of reducing and restoring basis of debt.

III. Elections Under Section 1368

The proposed regulations provide that if a shareholder disposes of 20 percent or more of the corporation's issued shares of stock in one or more transactions during any thirty-day period during the taxable year of the corporation (qualifying disposition), the corporation may elect to treat the taxable year as if it consists of separate taxable years, the first of which ends on the date on which the shareholder disposes of 20 percent or more of the corporation's issued stock. Some commentators suggested that the election for qualifying dispositions of stock should be expanded to include any 20 percent or greater disposition of stock (whether by a sale or exchange, by a redemption treated as an exchange, or by a stock issuance). In response to comments, the final regulations modify the rule in the proposed regulations to permit the election for other dispositions of an S corporation's stock.

IV. Rules Relating to the Accumulated Adjustments Account

Under the final regulations, only S corporations with earnings and profits must maintain an accumulated adjustments account (AAA) to determine the tax effect of distributions during S years and the post-termination transition period as defined in section 1377(b)(1). An S corporation without earnings and profits does not need to maintain the AAA in order to determine the tax effect of distributions. Nevertheless, if an S corporation without earnings and profits engages in certain transactions to which section 381(a) applies, such as a merger into an S corporation with C corporation earnings and profits, the S corporation must be able to calculate its AAA at the time of the merger for purposes of determining the tax effect of post-merger distributions.

A. Adjustments to AAA

One commentator suggested that adjustments to the AAA should mirror the statutory scheme for adjustments to basis in stock under section 1367, at least in the context of dividend distributions. Under the proposed regulations, a distribution taxed to a shareholder under section 1368(b)(2) (because it exceeds a shareholder's stock basis) reduces the AAA balance. The commentator recommended that the AAA should be decreased only by the portion of a distribution to which section 1368(b)(1) applies. In effect, under the commentator's suggestion, adjustments to the AAA would mirror adjustments to a shareholder's basis in stock and would limit reduction of the AAA to nontaxable distributions.

Section 1368(e)(1)(A) provides that the AAA is adjusted in a manner similar to basis in stock and S corporation debt, but does not require that it mirror shareholder level adjustments to basis in stock and S corporation debt. Furthermore, the rule in the proposed regulations is more consistent with the fact that the AAA is a corporate level account. The Service and the Treasury Department believe that the commentator's approach would create unnecessary complexity and uncertainty in the administration of the statute. The AAA is a corporate level account and an S corporation, which does not generally need to track a shareholder's basis in its stock, would need to determine a shareholder's basis to adjust the AAA upon a distribution.

Therefore, the final regulations do not adopt this commentator's suggested approach regarding adjustments to the AAA for distributions.

B. Redemption Distributions

Section 1368(e)(1)(B) provides that in the case of a redemption distribution that is treated as an exchange of stock under section 302(a) or section 303(a) (redemption distribution), the corporation's AAA is adjusted in an amount equal to the ratable share of the corporation's AAA attributable to the redeemed stock. In the case of a taxable year in which ordinary distributions and redemption distributions occur, the proposed regulations require an S corporation to determine the ratable share of the AAA attributable to redeemed stock under the method used to determine the pro rata portion of total earnings and profits attributable to shares redeemed in a C corporation. See Rev. Rul. 74-338, 1974-2 C.B. 101, and Rev. Rul. 74-339, 1974-2 C.B. 103. The Service invited and received comments regarding alternative approaches that appropriately reduce the AAA in the case of ordinary and redemption distributions.

While commentators generally acknowledged that the redemption rule in the proposed regulations is workable, they suggested the rule is unnecessarily complex. In response to comments, the final regulations modify the redemption rule. Under the final regulations, adjustments to the AAA are made first for passthrough items, second for ordinary distributions, and third for redemption distributions. For redemption distributions, an S corporation is required to adjust the AAA in an amount equal to the ratable share of the AAA attributable to the redeemed stock. The corporation also independently adjusts earnings and profits under the normal rules for C corporations.

V. Effective Date and Transition Rule

The final regulations under sections 1367 and 1368 apply to taxable years of the corporation beginning on or after January 1, 1994. For taxable years beginning before January 1, 1994, both the adjustments to the basis of a shareholder's stock and any indebtedness of the S corporation to a shareholder and the treatment of distributions by the S corporation to its shareholders must be determined in a reasonable manner. For purposes of the preceding sentence, return positions consistent with Secs. 1.1367-1, 1.1367-2, 1.1368-1, 1.1368-2, and 1.1368-3 (other than the deemed dividend election under Sec. 1.1368-1(f)(3)) are reasonable.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these final regulations is Deane M. Burke of the Office of Assistant Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service. However, other personnel from the Internal Revenue Service and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding the following citations in numerical order:

Authority: 26 U.S.C. 7805 * * *

Section 1.1368-1(f) and (g) also issued under 26 U.S.C. 1377(c).

Section 1.1368-2(b) also issued under 26 U.S.C. 1368(c).

Par. 2. Sections 1.1367-0 through 1.1367-3 and 1.1368-0 through 1.1368-4 are added to read as follows:

Sec. 1.1367-0 Table of contents.

The following table of contents is provided to facilitate the use of Secs. 1.1367-1 through 1.1367-3.

Sec. 1.1367-1 Adjustments to basis of shareholder's stock in an S corporation.

- (a) In general.
 - (1) Adjustments under section 1367.
 - (2) Applicability of other Internal Revenue Code provisions.
- (b) Increase in basis of stock.
 - (1) In general.
 - (2) Amount of increase in basis of individual shares.
- (c) Decrease in basis of stock.
 - (1) In general.
 - (2) Noncapital, nondeductible expenses.
 - (3) Amount of decrease in basis of individual shares.
- (d) Time at which adjustments to basis of stock are effective.
 - (1) In general.
 - (2) Adjustment for nontaxable item.
 - (3) Effect of election under section 1377(a)(2) or Sec. 1.1368-1(g)(2).
- (e) Ordering rules.
- (f) Elective ordering rule.
- (g) Examples.

Sec. 1.1367-2 Adjustments to basis of indebtedness to shareholder.

- (a) In general.
- (b) Reduction in basis of indebtedness.
 - (1) General rule.
 - (2) Termination of shareholder's interest in corporation during taxable year.
 - (3) Multiple indebtedness.
- (c) Restoration of basis.
 - (1) General rule.
 - (2) Multiple indebtedness.
- (d) Time at which adjustments to basis of indebtedness are effective.
 - (1) In general.
 - (2) Effect of election under section 1377(a)(2) or Sec. 1.1368-1(g)(2).
- (e) Examples.

Sec. 1.1367-3 Effective date and transition rule.

Sec. 1.1367-1 Adjustments to basis of shareholder's stock in an S corporation.

- (a) In general--(1) Adjustments under section 1367.

This section provides rules relating to adjustments required by section 1367 to the basis of a shareholder's stock in an S corporation. Paragraph (b) of this section provides rules concerning increases in the basis of a shareholder's stock, and paragraph (c) of this section provides rules concerning decreases in the basis of a shareholder's stock.

(2) Applicability of other Internal Revenue Code provisions. In addition to the adjustments required by section 1367 and this section, the basis of stock is determined or adjusted under other applicable provisions of the Internal Revenue Code.

(b) Increase in basis of stock--(1) In general. Except as provided in Sec. 1.1367-2(c) (relating to restoration of basis of indebtedness to the shareholder), the basis of a shareholder's stock in an S corporation is increased by the sum of the items described in section 1367(a)(1). The increase in basis described in section 1367(a)(1)(C) for the excess of the deduction for depletion over the basis of the property subject to depletion does not include the depletion deduction attributable to oil or gas property. See section 613(A)(c)(11).

(2) Amount of increase in basis of individual shares. The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the items described in section 1367(a)(1) that is attributable to that share, determined on a per share, per day basis in accordance with section 1377(a).

(c) Decrease in basis of stock--(1) In general. The basis of a shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the items described in section 1367(a)(2).

(2) Noncapital, nondeductible expenses. For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162.

(3) Amount of decrease in basis of individual shares. The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the passthrough items and distributions described in section 1367(a)(2) attributable to that share, determined on a per share, per day basis in accordance with section 1377(a). If the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares.

(d) Time at which adjustments to basis of stock are effective--(1) In general. The adjustments described in section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, if a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition.

(2) Adjustment for nontaxable item. An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

(3) Effect of election under section 1377(a)(2) or Sec. 1.1368-1(g)(2). If an election under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under Sec. 1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition) is made with respect to the taxable year of a corporation, this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest is terminated or a qualifying disposition occurs, whichever the case may be.

(e) Ordering rules. For any taxable year, except as provided in paragraph (f) of this section, the adjustments required by section 1367(a) are made in the following order:

(1) Any increase in basis attributable to the income items described in section 1367(a)(1) (A) and (B) and the excess of the deductions for depletion described in section 1367(a)(1)(C);

(2) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D) and the oil and gas depletion deduction described in section 1367(a)(2)(E);

(3) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2) (B) and (C); and

(4) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A).

(f) Elective ordering rule. A shareholder may elect to decrease basis under paragraph (e)(3) of this section prior to decreasing basis under paragraph (e)(2) of this section. If a shareholder makes this election, any amount described in paragraph (e)(2) of this section that is in excess of the shareholder's basis in stock and indebtedness is treated, solely for purposes of this section, as an amount described in paragraph (e)(2) of this section in the succeeding taxable year. A shareholder makes the election under this paragraph by attaching a statement to the shareholder's timely filed original or amended return that states that the shareholder agrees to the carryover rule of the preceding sentence. Once a shareholder makes an election under this paragraph with respect to an S corporation, the shareholder must continue to use the rules of this paragraph for that S corporation in future taxable years unless the shareholder receives the permission of the Commissioner.

(g) Examples. The following examples illustrate the principles of Sec. 1.1367-1. In each example, the corporation is a calendar year S corporation:

Example 1. Adjustments to basis of stock in general. (i) On December 31, 1994, A owns a block of 50 shares of stock with an adjusted basis per share of \$6 in Corporation S. On December 31,

1994, A purchases for \$400 an additional block of 50 shares of stock with an adjusted basis of \$8 per share. Thus, A holds 100 shares of stock for each day of the 1995 taxable year. For S's 1995 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1)(A) (relating to increases in basis of stock) is \$300, and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) and (D) (relating to decreases in basis of stock) is \$500. S makes a distribution to A in the amount of \$100 during 1995.

(ii) Pursuant to the ordering rules of paragraph (e) of this section, A increases the basis of each share of stock by \$3 (\$300/100 shares) and decreases the basis of each share of stock by \$5 (\$500/100 shares). Then A reduces the basis of each share by \$1 (\$100/100 shares) for the distribution. Thus, on January 1, 1996, A has a basis of \$3 per share in his original block of 50 shares (\$6+\$3-\$5 -\$1) and a basis of \$5 per share in the second block of 50 shares (\$8+\$3-\$5-\$1).

Example 2. Adjustments attributable to basis of individual shares of stock. (i) On December 31, 1993, B owns one share of S corporation's 10 outstanding shares of stock. The basis of B's share is \$30. On July 2, 1994, B purchases from another shareholder two shares for \$25 each. During 1994, S corporation has no income or deductions but incurs a loss of \$365. Under section 1377(a)(1)(A) and paragraph (c)(3) of this section, the amount of the loss assigned to each day of S's taxable year is \$1.00 (\$365/365 days). For each day, \$.10 is allocated to each outstanding share (\$.10 amount of loss assigned to each day/10 shares).

(ii) B owned one share for 365 days and, therefore, reduces the basis of that share by the amount of loss attributable to it, i.e., \$36.50 (\$.10 x 365 days). B owned two shares for 182 days and, therefore, reduces the basis of each of those shares by the amount of the loss attributable to each, i.e., \$18.20 (\$.10 x 182 days).

(iii) The bases of the shares are decreased as follows:

Share	Original basis	Decrease	Adjusted basis	Excess basis reduction
No. 1.....	\$30.00	\$36.50	\$0	\$6.50
No. 2.....	25.00	18.20	6.80	0
No. 3.....	25.00	18.20	6.80	0
Total remaining basis.....			13.60	

(iv) Because the decrease in basis attributable to share No. 1 exceeds the basis of share No. 1 by \$6.50 (\$36.50 - \$30.00), the excess is applied to reduce the bases of shares No. 2 and No. 3 in proportion to their remaining bases. Therefore, the bases of share No. 2 and share No. 3 are each decreased by an additional \$3.25 (\$6.50 x \$6.80/\$13.60). After this decrease, Share No. 1 has a basis of zero, Share No. 2 has a basis of \$3.55, and Share No. 3 has a basis of \$3.55.

Example 3. Effects of section 1377(a)(2) election and distribution on basis of stock. (i) On January 1, 1994, individuals B and C each own 50 of the 100 shares of issued and outstanding stock of Corporation S. B's adjusted basis in each share of stock is \$120, and C's is \$80. On June 30, 1994, S distributes \$6,000 to B and \$6,000 to C. On June 30, 1994, B sells all of her S stock for \$10,000 to D. S elects under section 1377(a)(2) to treat its 1994 taxable year as consisting of two taxable years, the first of which ends at the close of June 30, the date on which B terminates her interest in S.

(ii) For the period January 1, 1994, through June 30, 1994, S has nonseparately computed income of \$6,000 and a separately stated deduction item of \$4,000. Therefore, on June 30, 1994, B and C, pursuant to the ordering rules of paragraph (e) of this section, increase the basis of each share by \$60 (\$6,000/100 shares) and decrease the basis of each share by \$40 (\$4,000/100 shares). Then B and C reduce the basis of each share by \$120 (\$12,000/100 shares) for the distribution.

(iii) The basis of B's stock is reduced from \$120 to \$20 per share (\$120+\$60-\$40-\$120). The basis of C's stock is reduced from \$80 to \$0 per share (\$80+\$60-\$40-\$120). See section 1368 and Sec. 1.1368-1 (c) and (d) for rules relating to the tax treatment of the distributions.

(iv) Pursuant to paragraph (d)(3) of this section, the net reduction in the basis of B's shares of the S stock required by section 1367 and this section is effective immediately prior to B's

sale of her stock. Thus, B's basis for determining gain or loss on the sale of the S stock is \$20 per share, and B has a gain on the sale of \$180 (\$200-\$20) per share.

Sec. 1.1367-2 Adjustments to basis of indebtedness to shareholder.

(a) In general. This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness of an S corporation to a shareholder. For purposes of this section, shareholder advances not evidenced by separate written instruments and repayments on the advances (open account debt) are treated as a single indebtedness. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section.

(b) Reduction in basis of indebtedness--(1) General rule. If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2) (B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) Termination of shareholder's interest in corporation during taxable year. If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) Multiple indebtedness. If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) Restoration of basis--(1) General rule. If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any net increase in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, net increase with respect to a shareholder means the amount by which the shareholder's pro rata share of the items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

(2) Multiple indebtedness. If a shareholder holds more than one indebtedness as of the beginning of a corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness in proportion to the amount that the basis of each outstanding indebtedness has been reduced under section 1367(b)(2)(A) and paragraph (b) of this section and not restored under section 1367(b)(2)(B) and this paragraph (c).

(d) Time at which adjustments to basis of indebtedness are effective--(1) In general. The amounts of the adjustments to basis of indebtedness provided in section 1367(b)(2) and this section are determined as of the close of the corporation's taxable year, and the adjustments are generally effective as of the close of the corporation's taxable year. However, if the shareholder is not a shareholder in the corporation at that time, these adjustments are effective immediately before the shareholder terminates his or her interest in the corporation. If a debt is disposed of or repaid in

whole or in part before the close of the taxable year, the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the disposition or the first repayment on the debt during the taxable year.

(2) Effect of election under section 1377(a)(2) or Sec. 1.1368-1(g)(2). If an election is made under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under Sec. 1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition), this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder either terminates his or her interest in the corporation or disposes of a substantial amount of stock, whichever the case may be.

(e) Examples. The following examples illustrate the principles of Sec. 1.1367-2. In each example, the corporation is a calendar year S corporation. The lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example 1. Reduction in basis of indebtedness. (i) A has been the sole shareholder in Corporation S since 1992. In 1993, A loans S \$1,000 (Debt No. 1), which is evidenced by a ten-year promissory note in the face amount of \$1,000. In 1996, A loans S \$5,000 (Debt No. 2), which is evidenced by a demand promissory note. On December 31, 1996, the basis of A's stock is zero; the basis of Debt No. 1 has been reduced under paragraph (b) of this section to \$0; and the basis of Debt No. 2 has been reduced to \$1,000. On January 1, 1997, A loans S \$4,000 (Debt No. 3), which is evidenced by a demand promissory note. For S's 1997 taxable year, the sum of the amounts specified in section 1367(a)(1) (in this case, nonseparately computed income and the excess deduction for depletion) is \$6,000, and the sum of the amounts specified in section 1367(a)(2) (B), (D), and (E) (in this case, items of separately stated deductions and losses, noncapital, nondeductible expenses, and certain oil and gas depletion deductions--there is no nonseparately computed loss) is \$10,000. Corporation S makes no payments to A on any of the loans during 1997.

(ii) The \$4,000 excess of loss and deduction items is applied to reduce the basis of each indebtedness in proportion to the basis of that indebtedness over the aggregate bases of the indebtedness to the shareholder (determined immediately before any adjustment under section 1367(b)(2)(A) and paragraph (b) of this section is effective for the taxable year). Thus, the basis of Debt No. 2 is reduced in an amount equal to \$800 ($\$4,000$ (excess) \times $\$1,000$ (basis of Debt No. 2)/ $\$5,000$ (total basis of all debt)). Similarly, the basis in Debt No. 3 is reduced in an amount equal to \$3,200 ($\$4,000 \times \$4,000 / \$5,000$). Accordingly, on December 31, 1997, A's basis in his stock is zero and his bases in the three debts are as follows:

Debt	1/1/96 basis	12/31/96 reduction	1/1/97 basis	12/31/97 reduction	1/1/98 basis
No. 1.....	\$1,000	\$1,000	\$0	\$0	\$0
No. 2.....	5,000	4,000	1,000	800	200
No. 3.....			4,000	3,200	800

Example 2. Restoration of basis of indebtedness. (i) The facts are the same as in Example 1. On July 1, 1998, S completely repays Debt No. 3, and, for S's 1998 taxable year, the net increase (within the meaning of paragraph (c) of this section) with respect to A equals \$4,500.

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals \$9,000. Thus, the basis of Debt No. 3 is restored by \$3,200 (the amount of the previous reduction) to \$4,000. A's basis in Debt No. 3 is treated as restored immediately before that debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of \$1,300 ($\$4,500 - \$3,200$) is applied to restore the bases of Debt No. 1 and

Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is \$5,800 (\$9,000-\$3,200). The basis of Debt No. 1 is restored in an amount equal to \$224 (\$1,300 x \$1,000/\$5,800). Similarly, the basis in Debt No. 2 is restored in an amount equal to \$1,076 (\$1,300 x \$4,800/\$5,800). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

Original basis	Amount reduced	1/1/98 basis	Amount restored	12/31/98 basis
\$1,000.....	\$1,000	\$0	\$224	\$224
5,000.....	4,800	200	1,076	1,276

Example 3. Full restoration of basis in indebtedness when debt is repaid in part during the taxable year. (i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S \$1,000. S issues its note to C in the amount of \$1,000, of which \$950 is payable on March 1, 1998, and \$50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to \$900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is \$300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under Sec. 1.1367-2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or \$1,000. Therefore, \$100 of the \$300 net increase is applied to restore the basis of the debt from \$900 to \$1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of \$200 increases C's basis in her stock.

Example 4. Determination of net increase--distribution in excess of increase in basis. (i) D has been the sole shareholder in Corporation S since 1990. On January 1, 1996, D loans S \$10,000 in return for a note from S in the amount of \$10,000 of which \$5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to \$8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals \$10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals \$0. During 1998, S also makes distributions to D totaling \$11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and must be taken into account for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The \$10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the \$11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to \$0. See section 1368 and Sec. 1.1368-1 (c) and (d) for the tax treatment of the \$1,000 distribution in excess of D's basis.

Example 5. Distributions less than increase in basis. (i) The facts are the same as in Example 4, except that in 1998 S makes distributions to D totaling \$8,000. On these facts, for 1998, there is a net increase with respect to D of \$2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of \$2,000 with respect to D for 1998, \$2,000 of the \$10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to \$10,000 (\$8,000 + \$2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of \$0 (\$0 + \$8,000 (increase in basis remaining after restoring basis in indebtedness)--\$8,000 (distribution)) and a basis in the note of \$10,000.

Sec. 1.1367-3 Effective date and transition rule.

Sections 1.1367-1 and 1.1367-2 apply to taxable years of a

corporation beginning on or after January 1, 1994. For taxable years beginning before January 1, 1994, the adjustments to the basis of a shareholder's stock and the basis of indebtedness of an S corporation to a shareholder must be determined in a reasonable manner, taking into account the statute and the legislative history. Return positions consistent with Secs. 1.1367-1 and 1.1367-2 are reasonable.

Sec. 1.1368-0 Table of contents.

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Sec. 1.1368-3 Examples.

Sec. 1.1368-4 Effective date and transition rule.

Sec. 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)(1), (2), and (3). See section 316 and Sec. 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 Sec. 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. Paragraphs (c) and (d) of this section are applied only after taking into account--

(1) 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

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

(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 distribute 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 this paragraph (f) by attaching a statement to a timely filed 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 Sec. 1.1368-1(f) and must state that each shareholder consents to the election. An officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. A statement of election to make a deemed dividend under this paragraph 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 Sec. 1.1368-1(g)(2) is disregarded.

(g) Special rules--(1) Election to terminate year under section 1377 or Sec. 1.1368-1(g)(2). If an election is made under section 1377(a)(2) (to terminate the year when a shareholder terminates his or her interest in the corporation) or 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 the shareholder terminates his or her interest in the corporation or on which there is a qualifying disposition of stock, whichever the case may be.

(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.

(iii) Time and manner of making election. A corporation makes an election under paragraph (g)(2)(i) of this section for a taxable year by attaching a statement to a timely filed original or amended return required to be filed under section 6037 for a taxable year (without regard to the election under paragraph (g)(2)(i) of this section). In the statement, the corporation must state that it is electing for the taxable year under Sec. 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 paragraph (g)(2)(i) of this section) consents to this election. An officer of the corporation must sign under penalties of perjury the statement on behalf of the corporation. 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 paragraph (g)(2)(i) of this section for the taxable year. An election made under paragraph (g)(2)(i) of this section is irrevocable.

Sec. 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, 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 Sec. 1.1367-1(f) (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 or deduction or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under section 1366(d)(2) or Sec. 1.1367-1(f) (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 any taxable year, 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;

(iii) The AAA is decreased (but not below zero) by any portion of an ordinary distribution to which section 1368(b) or (c)(1) applies; and

(iv) The AAA is adjusted (whether negative or positive) for redemption distributions under paragraph (d)(1) of this section.

(b) Distributions in excess of the AAA--(1) In general. A portion of the AAA (determined under paragraph (b)(2) of this section) is allocated to each of the distributions made for the taxable year if--

(i) An S corporation makes more than one distribution of property with respect to its stock during the taxable year of the corporation (including an S short year as defined under section 1362(e)(1)(A));

(ii) The AAA has a positive balance at the close of the year; and

(iii) The sum of the distributions made during the corporation's taxable year exceeds the balance of the AAA at the close of the year.

(2) Amount of the AAA allocated to each distribution. The amount of the AAA allocated to each distribution is determined by multiplying the balance of the AAA at the close of the current taxable year by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the amount of all distributions made during the taxable year. For purposes of this paragraph (b)(2), the term all distributions made during the taxable year does not include any distribution treated as from earnings and profits or previously taxed income pursuant to an election made under section 1368(e)(3) and Sec. 1.1368-1(f)(2). See paragraph (d)(1) of this section for rules relating to the adjustments to the AAA for redemptions and distributions in the year of a redemption.

(c) Distribution of money and loss property--(1) In general. The amount of the AAA allocated to a distribution under this section must be further allocated (under paragraph (c)(2) of this section) if the distribution--

(i) Consists of property the adjusted basis of which exceeds its fair market value on the date of the distribution and money;

(ii) Is a distribution to which Sec. 1.1368-1(d)(1) applies; and

(iii) Exceeds the amount of the corporation's AAA properly allocable to that distribution.

(2) Allocating the AAA to loss property. The amount of the AAA allocated to the property other than money is equal to the amount of the AAA allocated to the distribution multiplied by a fraction, the numerator of which is the fair market value of the property other than money on the date of distribution and the denominator of which is the amount of the distribution. The amount of the AAA allocated to the money is equal to the amount of the AAA allocated to the distribution reduced by the amount of the AAA allocated to the property other than money.

(d) Adjustment in the case of redemptions, reorganizations, and divisions--(1) Redemptions--(i) General Rule. In the case of a redemption distribution by an S corporation that is treated as an exchange under section 302(a) or section 303(a) (a redemption

distribution), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

(ii) Special rule for years in which a corporation makes both ordinary and redemption distributions. In any year in which a corporation makes one or more distributions to which section 1368(a) applies (ordinary distributions) and makes one or more redemption distributions, the AAA of the corporation is adjusted first for any ordinary distributions and then for any redemption distributions.

(iii) Adjustments to earnings and profits. Earnings and profits are adjusted under section 312 independently of any adjustments made to the AAA.

(2) Reorganizations. An S corporation acquiring the assets of another S corporation in a transaction to which section 381(a)(2) applies will succeed to and merge its AAA (whether positive or negative) with the AAA (whether positive or negative) of the distributor or transferor S corporation as of the close of the date of distribution or transfer. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior to the transaction.

(3) Corporate separations to which section 368(a)(1)(D) applies. If an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under section 312 (h). See Sec. 1.312-10(a).

(e) Election to terminate year under section 1377(a)(2) or Sec. 1.1368-1(g)(2). If an election is made under section 1377(a)(2) (to terminate the year in the case of termination of a shareholder's interest) or Sec. 1.1368-1(g)(2) (to terminate the year in the case of 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 the shareholder terminated his or her interest in the corporation or makes a substantial disposition of stock, whichever the case may be.

Sec. 1.1368-3 Examples.

The principles of Secs. 1.1368-1 and 1.1368-2 are illustrated by the examples below. In each example Corporation S is a calendar year corporation:

Example 1. Distributions by S corporations without C corporation earnings and profits. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 1996, the first day of its 1996 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of \$1 per share as of that date. On March 1, 1996, S makes a distribution of \$38 to A. For S's 1996 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is \$50 and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) through (D) (relating to decreases in basis of stock for items other than distributions) is \$26.

(ii) Under section 1368(d)(1) and Sec. 1.1368-1(e)(1), the adjustments to the bases of A's stock in S described in section 1367 are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is \$3.40 ($\$1 + [(\$50 - \$26) / 10 \text{ shares}]$) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under Sec. 1.1367-1(c)(3), the amount of the distribution that is attributable to each share of A's stock is \$3.80 ($\$38 \text{ distribution} / 10 \text{ shares}$). However, A only has a basis of \$3.40 in each share, and basis may not be reduced below zero. Therefore, the basis of each share of his stock is reduced by \$3.40 to zero, and the remaining \$4.00 of the distribution ($[\$3.80 - \$3.40] \times 10 \text{ shares}$) is treated as gain from the sale or exchange of property. As of January 1, 1997, A has a basis of \$0 in his shares of S stock.

Example 2. Distributions by S corporations with C corporation earnings and profits. (i) Corporation S properly elects to be an S corporation beginning January 1, 1997, and as of that date has accumulated earnings and profits of \$30. B, an individual and sole

shareholder of Corporation S, has 10 shares of S stock with a basis of \$12 per share. In addition, B lends \$30 to S evidenced by a demand note.

(ii) During 1997, S has a nonseparately computed loss of \$150. S makes no distributions to B during 1997. Under section 1366(d)(1), B is allowed a loss equal to \$150, the amount equal to the sum of B's bases in his shares of stock and his basis in the debt. Under section 1367, the loss reduces B's adjusted basis in his stock and debt to \$0. Under Sec. 1.1368-2(a)(3), S's AAA as of December 31, 1997, has a deficit of \$150 as a result of S's loss for the year.

(iii) For 1998, S has \$220 of separately stated income and distributes \$110 to B. The balance in the AAA (negative \$150 from 1997) is increased by \$220 for S's income for the year and decreased to \$0 for the portion of the distribution that is treated as being from the AAA (\$70). Under Sec. 1.1367-2(c), B's net increase is \$150, determined by reducing the \$220 of income by the \$70 of the distribution not includible in income by B. Thus, B's basis in the debt is fully restored to \$30, and B's basis in S stock (before accounting for the distribution) is increased from zero to \$19 per share $([\$220 - \$30 \text{ applied to the debt}] / 10)$. Thirty dollars of the distribution is considered a dividend to the extent of S's \$30 of earnings and profits, and the remaining \$10 of the distribution reduces B's basis in the S stock. Thus, B's basis in the S stock as of December 31, 1998, is \$11 per share $(\$19 - [\$70 \text{ AAA distribution} / 10] - [10 \text{ distribution treated as a reduction in basis} / 10])$. The balance in the AAA is \$0, S's earnings and profits are \$0, and B's basis in the loan is \$30.

Example 3. Election in case of disposition of substantial amount of stock. (i) Corporation S, an S corporation, has earnings and profits of \$3,000 and a balance in the AAA of \$1,000 on January 1, 1997. C, an individual and the sole shareholder of Corporation S, has 100 shares of S stock with a basis of \$10 per share. On July 3, 1997, C sells 50 shares of his S stock to D, an individual, for \$250. For 1997, S has taxable income of \$1,000, of which \$500 was earned on or before July 3, 1997, and \$500 earned after July 3, 1997. During its 1997 taxable year, S distributes \$1,000 to C on February 1 and \$1,000 to each of C and D on August 1. S does not make the election under section 1368(e)(3) and Sec. 1.1368-1(f)(2) to distribute its earnings and profits before its AAA. S makes the election under Sec. 1.1368-1(g)(2) to treat its taxable year as if it consisted of separate taxable years, the first of which ends at the close of July 3, 1997, the date of the qualifying disposition.

(ii) Under section Sec. 1.1368-1(g)(2), for the period ending on July 3, 1997, S's AAA is \$500 $(\$1,000 \text{ (AAA as of January 1, 1997)} + \$500 \text{ (income earned from January 1, 1997 through July 3, 1997)} - \$1,000 \text{ (distribution made on February 1, 1997)})$. C's bases in his shares of stock is decreased to \$5 per share $(\$10 \text{ (original basis)} + \$5 \text{ (increase per share for income)} - \$10 \text{ (decrease per share for distribution)})$.

(iii) The AAA is adjusted at the end of the taxable year for the period July 4 through December 31, 1997. It is increased from \$500 (AAA as of the close of July 3, 1997) to \$1,000 for the income earned during this period and is decreased by \$1,000, the portion of the distribution (\$2,000 in total) made to C and D on August 1 that does not exceed the AAA. The \$1,000 portion of the distribution that remains after the AAA is reduced to zero is attributable to earnings and profits. Therefore C and D each have a dividend of \$500, which does not affect their basis or S's AAA. The earnings and profits account is reduced from \$3,000 to \$2,000.

(iv) As of December 31, 1997, C and D have bases in their shares of stock of zero $(\$5 \text{ (basis as of July 4)} + \$5 \text{ (}\$500 \text{ income}/100 \text{ shares)} - \$10 \text{ (}\$1,000 \text{ distribution}/100 \text{ shares)})$. C and D each will report \$500 as dividend income, which does not affect their basis or S's AAA.

Example 4. Election to distribute earnings and profits first.

(i) Corporation S has been a calendar year C corporation since 1975. For 1982, S elects for the first time to be taxed under subchapter S, and during 1982 has \$60 of earnings and profits. As of December 31, 1995, S has an AAA of \$10 and earnings and profits of \$160, consisting of \$100 of subchapter C earnings and profits and \$60 of subchapter S earnings and profits. For 1996, S has \$200 of taxable income and the AAA is increased to \$210 (before taking distributions into account). During 1996, S distributes \$240 to its shareholders. With its 1996 tax return, S properly elects under section 1368(e)(3) and Sec. 1.1368-1(f)(2) to distribute its earnings and profits before its AAA.

(ii) Because S elected to distribute its earnings and profits before its AAA, the first \$100 of the distribution is characterized as a distribution from subchapter C earnings and profits; the next \$60 of the distribution is characterized as a distribution from

subchapter S earnings and profits. Because \$160 of the distribution is from earnings and profits, the shareholders of S have a \$160 dividend. The remaining \$80 of the distribution is a distribution from S's AAA and is treated by the shareholders as a return of capital or gain from the sale or exchange of property, as appropriate, under Sec. 1.1368-1(d)(1). S's AAA, as of December 31, 1996, equals \$130 (\$210-\$80).

Example 5. Distributions in excess of the AAA. (i) On January 1, 1995, Corporation S has \$40 of earnings and profits and a balance in the AAA of \$100. S has two shareholders, E and F, each of whom own 50 shares of S's stock. For 1995, S has taxable income of \$50, which increases the AAA to \$150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes \$60 to each shareholder. On September 1, 1995, S distributes \$30 to each shareholder. S does not make the election under section 1368(e)(3) and Sec. 1.1368-1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The sum of the distributions exceed S's AAA. Therefore, under Sec. 1.1368-2(b), a portion of S's \$150 balance in the AAA as of December 31, 1995, is allocated to each of the February 1 and September 1 distributions based on the respective sizes of the distributions. Accordingly, S must allocate \$100 ($\$150 \text{ (AAA)} \times (\$120 \text{ (February 1 distribution)} / \$180 \text{ (the sum of the distributions)})$) of the AAA to the February 1 distribution, and \$50 ($\$150 \times (\$60 / \$180)$) to the September 1 distribution. The portions of the distributions to which the AAA is allocated are treated by the shareholder as a return of capital or gain from the sale or exchange of property, as appropriate. The remainder of the two distributions is treated as a dividend to the extent that it does not exceed S's earnings and profits. E and F must each report \$10 of dividend income for the February 1 distribution. For the September 1 distribution, E and F must each report \$5 of dividend income.

Example 6. Ordinary and redemption distributions in the same taxable year. (i) On January 1, 1995, Corporation S, an S corporation, has \$20 of earnings and profits and a balance in the AAA of \$10. S has two shareholders, G and H, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of \$16, which increases the AAA to \$26 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes \$10 to each shareholder. On December 31, 1995, S redeems for \$13 all of shareholder G's stock in a redemption that is treated as a sale or exchange under section 302(a).

(ii) The sum of the ordinary distributions does not exceed S's AAA. Therefore, S must reduce the \$26 balance in the AAA by \$20 for the February 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or gain from the sale or exchange of property. S must adjust the remaining AAA, \$6, in an amount equal to the ratable share of the remaining AAA attributable to the redeemed stock, or \$3 ($50\% \times \6).

(iii) S also must adjust the earnings and profits of \$20 in an amount equal to the ratable share of the earnings and profits attributable to the redeemed stock. Therefore, S adjusts the earnings and profits by \$10 ($50\% \times \20), the ratable share of the earnings and profits attributable to the redeemed stock.

Sec. 1.1368-4 Effective date and transition rule.

Sections 1.1368-1, 1.1368-2, and 1.1368-3 apply to taxable years of a corporation beginning on or after January 1, 1994. For taxable years beginning before January 1, 1994, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and the legislative history. Except with regard to the deemed dividend rule under Sec. 1.1368-1(f)(3), return positions consistent with Secs. 1.1368-1, 1.1368-2, and 1.1368-3 are reasonable.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read:

Authority: 26 U.S.C. 7805.

Par. 13. Section 602.101(c) is amended by adding the following entries in numerical order to the table to read as follows:

Sec. 602.101 OMB Control numbers.

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(c) * * *

CFR part or section where identified	Current OMB control Number
* * * * *	
1.1367-1(f).....	1545-1139
1.1368-1(f)(2).....	1545-1139
1.1368-1(f)(3).....	1545-1139
1.1368-1(f)(4).....	1545-1139
1.1368-1(g)(2).....	1545-1139
* * * * *	

Margaret Milner Richarson,
 Commissioner of Internal Revenue.
 Approved: December 21, 1993.
 Leslie Samuels,
 Assistant Secretary of the Treasury (Tax Policy).
 [FR Doc. 93-31928 Filed 12-30-93; 8:45 am]
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