Part I.

Section 1368.—Distributions

26 CFR 1.1368-1: Distributions by S corporations

(Also: §§ 301, 302, 1362, 1367, 1371, 1377, 26 CFR 1.1368-2)


ISSUE

If, during a former S corporation’s post-termination transition period, the corporation distributes cash in redemption of a shareholder’s stock and the distribution is characterized as a distribution under § 301 of the Internal Revenue Code (Code), should the corporation reduce its accumulated adjustments account (AAA) pursuant to § 1368 of the Code?

FACTS

X is a corporation that once was a C corporation and later elected to be an S corporation under § 1362(a) of the Code. X’s S election terminated under § 1362(d), such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. X is a calendar-year taxpayer. At the time of its conversion to an S corporation, X had accumulated earnings and profits (E&P) of $600x and no current E&P. At the time of the termination of its S election, X’s AAA was $800x and its accumulated E&P was still $600x. During X’s post-termination transition period, X redeems 50 of A’s 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. Pursuant to § 302(d) of the Code, the
redemption is characterized as a distribution subject to § 301. For the taxable period that includes the redemption, X has current E&P of $400x.

LAW AND ANALYSIS

Section 1371(e) of the Code provides that, in general, any distribution of cash by a former S corporation with respect to its stock during the post-termination transition period (as defined in § 1377(b) of the Code) is applied against and reduces the adjusted basis of the stock to the extent the distribution does not exceed the corporation’s AAA (within the meaning of § 1368(e)). Section 1368(e) defines the AAA as an account of the S corporation, which is adjusted for the S period in a manner similar to the adjustments under § 1367 of the Code (except that no adjustment is made for income (and related expenses) that is exempt from tax under the Code; the phrase “(but not below zero)” is disregarded in § 1367(a)(2)); and no adjustment is made for Federal taxes attributable to any taxable year in which the corporation was a C corporation. The term “S period” is defined in § 1368(e)(2) as the most recent continuous period during which the corporation has been an S corporation.

HOLDING

If, during a former S corporation’s post-termination transition period, the corporation distributes cash in redemption of a shareholder’s stock, which is characterized as a distribution subject to § 301, the corporation should reduce its AAA to the extent of the proceeds of the redemption pursuant to § 1368. The redemption of 50 of A’s 100 shares of X stock for $1,000x is characterized as a reduction of X’s $800x of AAA with the remaining $200x characterized as a dividend under § 301(c)(1).
DRAFTING INFORMATION

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