This document has been submitted to the Office of the Federal Register (OFR) for publication and will be pending placement on public display at the OFR and publication in the Federal Register. The version of the final rule released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9914]

RIN 1545-BP20

Eligible Terminated S Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations providing guidance on the definition of an eligible terminated S corporation and rules relating to distributions of money by such a corporation after the post-termination transition period. This document also amends current regulations to extend the treatment of distributions of money during the post-termination transition period to all shareholders of the corporation and clarifies the allocation of current earnings and profits to distributions of money and other property. The final regulations affect C corporations that were formerly S corporations and the shareholders of such corporations.

DATES: Effective Date: These regulations are effective **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.481-6(b), 1.1371-1(e), 1.1371-2(d), and 1.1377-3(c).

FOR FURTHER INFORMATION CONTACT: Concerning §§1.481-5, 1.481-6, 1.1362-2(a)(2)(iii), 1.1377-2, and 1.1377-3, Margaret Burow or Michael Gould at (202) 317-5279; concerning §§1.1371-1 and 1.1371-2, Aglaia Ovtchinnikova at (202) 317- 6975 or Margaret Burow or Michael Gould at (202) 317-5279; concerning §1.316-2, Aglaia Ovtchinnikova at (202) 317-6975.

SUPPLEMENTARY INFORMATION:

Background

In the case of an S corporation, as defined in section 1361(a)(1) of the Internal Revenue Code (Code), having accumulated earnings and profits (as described in section 316(a)(1) of the Code (AE&P)) that makes a distribution of property to which section 301 would otherwise apply, section 1368(c)(1) of the Code generally treats the amount of the distribution not in excess of the S corporation's accumulated adjustments account (as defined in §1.1368-2(a)(1) (AAA)) or the recipient shareholder's adjusted basis in such S corporation's stock as excluded from the shareholder's gross income. Section 1368(c)(2) provides that the remaining portion of the distribution is treated as a dividend (as defined in section 316(a)) to the extent of the S corporation's AE&P. Finally, section 1368(c)(3) provides that any amount of the distribution in excess of the S corporation's AAA and AE&P is applied against the shareholder's remaining adjusted basis in the stock, with any amount exceeding that adjusted basis treated as gain from the sale or exchange of property.

Generally, a distribution by a C corporation to its shareholders with respect to their stock ownership is treated as a taxable dividend to the extent of the corporation's earnings and profits. See sections 301(c) and 316(a). However, following the termination of a corporation's S election made under section 1362 of the Code (S election), section 1371(e) of the Code allows shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's post-termination transition period (PTTP), which is generally the one-year period after the corporation terminates its S election. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's AAA. The receipt of such a distribution is tax-free to the extent of the recipient shareholder's basis in its stock and the corporation's AAA balance. If the distribution exceeds the recipient shareholder's basis in its stock, but not the corporation's AAA, then the distribution is tax-free to the extent of the recipient shareholder's basis, with the remainder treated as gain from the sale of property. If the distribution exceeds the corporation's AAA, then the excess is taxed as a dividend from current earnings and profits (as described in section 316(a)(2) (CE&P)) or any AE&P from the corporation's previous existence as a corporation taxed under subchapter C. Without section 1371(e), shareholders of the former S corporation would be precluded from receiving distributions allocable to AAA.

Section 13543(a) and (b) of Public Law 115-97, 131 Stat. 2054, 2155 (2017), commonly referred to as the Tax Cuts and Jobs Act (TJCA), amended the Code by adding new sections 481(d) and 1371(f), effective as of December 22, 2017, the date of enactment of the TCJA.

Section 481(d)(1) of the Code permits a corporation that qualifies as an eligible terminated S corporation (ETSC) to take into account any 481 adjustments (as defined in part II.C of the Summary of Comments and Explanation of Revisions) which are attributable to the revocation of an S election over the section 481(d) inclusion period, which is the six-taxable-year-period beginning with the year of change (as defined in part II.C of the Summary of Comments and Explanation of Revisions). Section 481(d)(2) defines an ETSC as a C corporation meeting the following three requirements: (i) the corporation was an S corporation on December 21, 2017; (ii) the S corporation revoked its election under section 1362(a) to be an S corporation (that is, the S election) during the two-year period beginning on December 22, 2017 (revocation requirement); and (iii) the owners of the stock of the corporation, determined on the date the corporation made a revocation of its S election, are the same owners (and own identical proportions of the corporation's stock) as on December 22, 2017 (shareholder identity requirement).

Section 1371(f) extends the period during which shareholders of an ETSC can benefit from its AAA generated during the corporation's former status as an S corporation (ETSC period) by providing that, in the case of distributions of money following the PTTP, (i) the distributing ETSC's AAA is allocated to a distribution of money to which section 301 would otherwise apply (qualified distribution), and (ii) the qualified distribution is chargeable to AE&P in the same ratio as the amount of such AAA bears to the amount of such AE&P. In enacting section 1371(f), Congress determined that "it is important to provide rules to ease the transition from S corporation to C corporation for the affected taxpayers" because, based on the TCJA's revisions to

the Code, “taxpayers that previously elected to be taxed as S corporations may prefer instead to be taxed as C corporations.” H. Rept. 115-409, 115th Cong., 1st Sess., at 245 (Nov. 14, 2017) (House Report).

On November 7, 2019, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-131071-18) in the **Federal Register** (84 FR 60011) containing proposed regulations under section 1371 and proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 481 and 1377 (proposed regulations). The Treasury Department and the IRS received 16 written or electronic comments responding to the proposed regulations. All comments received on the proposed regulations are available at http://www.regulations.gov or upon request. As no request for a public hearing was received, no hearing was held. After full consideration of the comments received, this Treasury decision adopts generally the proposed regulations with certain modifications in response to the comments received, as described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions discusses those revisions, as well as the comments received in response to the proposed regulations.

II. Comments on Qualification as an Eligible Terminated S Corporation

A. Significance of date of revocation of S election

To qualify as an ETSC under section 481(d)(2), a corporation must satisfy the revocation requirement by making a revocation of its S election during the two-year period beginning on December 22, 2017 (two-year period). See section 481(d)(2)(A)(ii) (setting forth the revocation requirement); proposed §1.481-5(b)(2) (same). In addition, the shareholder identity requirement must be satisfied by the same shareholders owning identical proportions of the corporation's stock on two dates: December 22, 2017, and the date on which the corporation made a revocation of its S election. See section 481(d)(2)(B) (setting forth the shareholder identity requirement); proposed §1.481-5(b)(3) (same). But see proposed §1.481-5(c)(1) (identifying five categories of share transfers that do not result in a change in shareholder ownership for purposes of section 481(d)(2)(B)). Consequently, the date on which a corporation makes a revocation of its S election is critical for determining ETSC qualification.

A corporation can allow the effective date of its S election revocation to occur automatically by operation of section 1362(d)(1)(C), or it can specify an effective date under section 1362(d)(1)(D). For example, a revocation made before the 16th day of the third month of an S corporation's taxable year generally is effective retroactively on the first day of that taxable year. See section 1362(d)(1)(C)(i); §1.1362-2(a)(2)(i). In contrast, a revocation made after the 15th day of the third month of a corporation's taxable year generally is effective prospectively on the first day of the corporation's following taxable year. See section 1362(d)(1)(C)(ii); §1.1362-2(a)(2)(i). Alternatively, the corporation may specify an immediate or prospective effective date for a revocation by expressing a date (in terms of a stated day, month, and year) that occurs on or after

the date on which the revocation is made. See section 1362(d)(1)(D); §1.1362-2(a)(2)(ii).

1. Retroactive Effective Date of the Revocation Determines ETSC Status

One commenter suggested that the final regulations revise proposed §1.481-5(b)(2) to confirm that, in the case of a revocation with a retroactive effective date pursuant to section 1362(d)(1)(C)(i), the revocation may be treated as occurring on the retroactive effective date for purposes of ETSC qualification. Based on the stated congressional goal of facilitating the transition from S corporation status to C corporation status, the commenter contended that taxpayers reasonably could have interpreted the statute to indicate that compliance with the shareholder identity requirement would be tested on the retroactive revocation's effective date. In support of this contention, the commenter correctly noted that, in the absence of such an interpretation, a corporation would not satisfy the shareholder identity requirement for qualifying as an ETSC in proposed §1.481-5(b)(2) and (3) if the corporation (i) had the same shareholders (and in identical proportions) on both December 22, 2017, and the retroactive effective date of the revocation, but (ii) experienced a change in shareholder ownership during the period between the retroactive effective date of the revocation and the date on which the revocation was made.

The Treasury Department and the IRS agree with the commenter's interpretation. Proposed §1.481-5(b)(2) and (3) directly address revocations with prospective effective dates, which can be specified with significant flexibility in the revocation. A retroactive effective date for a revocation results solely by operation of section 1362(d)(1)(C)(i) and §1.1362-2(a)(2)(i) and, in such instance, is always effective on the first day of the

corporation’s taxable year. To confirm the commenter’s interpretation, §1.481-5(c)(2) of the final regulations provides that, solely with regard to revocations with retroactive effective dates, a revocation may be treated as having been made on the effective date of such revocation. Accordingly, for purposes of §1.481-5(b)(2) and (3), a corporation may test compliance with the revocation requirement and the shareholder identity requirement on either the date the revocation was made or, in the case of a revocation with a retroactive effective date, the date the revocation was effective.

2. Application of Section 7503 to a Revocation of an S Election

As discussed in part II.A of this Summary of Comments and Explanation of Revisions, the revocation requirement of section 481(d)(2)(A)(ii) requires that a corporation must make a revocation during the two-year period to qualify as an ETSC. Section 7503 provides that, “when the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday.” Because a revocation is an act made under authority of the internal revenue laws (that is, section 1362 of the Code), section 7503 applies for purposes of determining whether the revocation was made within the required two-year period. As a result of the application of section 7503 in conjunction with section 1362 and §1.1362-2(a)(2), December 23, 2019 (a Monday), is the last day of the two-year period. Therefore, a revocation made on that date would be treated as made within the two-year period. Without the application of section 7503, December 21, 2019 (a Saturday), would have been the last day of the two-year period.

To avoid any doubt, these final regulations clarify the text of §1.1362-2(a)(2) to provide explicitly that section 7503 applies where the last day prescribed for making a revocation occurs on a Saturday, Sunday, or legal holiday. Therefore, a revocation made on December 23, 2019, will be treated as made during the two-year period.

B. Applicability of PTTP and ETSC period to S corporations with no AE&P

Following the termination of an S election, section 1371(e) permits shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's PTTP, which generally is the one-year period after the corporation terminates its S election. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's AAA. The receipt of such a distribution is tax-free to the extent of the recipient shareholder's basis in the stock with respect to which the shareholder received the distribution, and is taxed as gain from the sale of property to the extent the distribution exceeds the shareholder's basis in that stock. See section 1371(e)(1). If the corporation exhausts its AAA during the PTTP, subsequent distributions are subject to treatment under section 301.

A commenter requested confirmation that the rules regarding distributions made during the PTTP, including section 1371(e) and §1.1377-2, apply if the corporation did not have AE&P at the time that it terminated its S election. Section 1371(e)(1) provides special treatment to distributions made by a corporation during the PTTP if such distributions (i) consist of money and (ii) are made with respect to the corporation's stock. Those two conditions would be satisfied regardless of whether the distributing corporation had AE&P. Therefore, the Treasury Department and the IRS agree with the

commenter's interpretation of section 1371(e) and §1.1377-2, but have determined that no clarifying revisions to the regulations are necessary in this regard.

The commenter also requested confirmation that the rules regarding distributions made during the ETSC period would apply if the distributing corporation did not have AE&P as of the effective date of the revocation. Example 1 of proposed §1.1371-1(d) illustrates that, if an ETSC has no AE&P as of the beginning of the day on which the revocation is effective, its historical AE&P is zero. Pursuant to proposed §1.1371-1(a)(2)(ix) and (x), such a corporation would enter its ETSC period with a AAA ratio of 1 and an AE&P ratio of zero. Therefore, each qualified distribution would be characterized as a distribution of AAA. Based on the guidance provided in Example 1, as well as the definition of the "AAA ratio" set forth in proposed §1.1371-1(a)(ii), the Treasury Department and the IRS have determined that no clarifying revisions to the regulations are necessary in this regard.

C. Application of section 481(d) to qualified subchapter S subsidiaries

If an S corporation wholly owns the stock of a domestic C corporation that is not an ineligible corporation described in section 1361(b)(2), the S corporation may elect under section 1361(b)(3)(B)(ii) and §1.1361-3 to treat the C corporation as a qualified subchapter S subsidiary (QSub) such that (i) the QSub will no longer be treated as a separate corporation and (ii) all of the QSub's assets, liabilities, and items of income, deduction, and credit will be treated as assets, liabilities, and such items (as the case may be) of the S corporation parent. If the requirements of section 1361(b)(3)(B) cease to be satisfied with respect to a QSub, including by reason of the revocation of the parent's S election, section 1361(b)(3)(C)(i) and §1.1361-5(b)(1)(i) provide that the

corporation's QSub election is terminated such that the QSub is treated, for purposes of the Code, as (i) a newly formed C corporation subsidiary separate from the parent and (ii) acquiring all of its assets (and assuming all of its liabilities) from the parent through an exchange to which section 351 of the Code applies (deemed section 351 exchange).

If the taxable income of any taxpayer, including a corporation, for the current year (year of change) is computed under a method of accounting that is different from the method of accounting used by the taxpayer in the preceding year (accounting method change), section 481 requires that the taxpayer must take into account those adjustments that are determined to be necessary solely by reason of the accounting method change to prevent items of income or expense from being duplicated or omitted (481 adjustments). Section 481(a). The 481 adjustments are generally taken into account in computing the taxpayer's taxable income in the year of change. However, section 481(c) permits a taxpayer, in such manner and subject to such conditions prescribed in regulations by the Secretary of the Treasury or his delegate (Secretary), to take 481 adjustments into account in computing taxable income for the taxable year or years permitted under such regulations. As noted earlier, section 481(d)(1) permits an ETSC to take into account any 481 adjustments that are attributable to the revocation of an S election over a six-taxable year period beginning with the year of change (that is, the section 481(d) inclusion period).

Commenters have correctly observed that section 481(a) and (d) do not apply to an ETSC's newly formed C corporation subsidiary (ETSC corporate subsidiary) that operated as a QSub prior to the revocation of its parent's S election. Upon such a revocation, the ETSC corporate subsidiary is treated as acquiring all of its assets and

assuming all of its liabilities from the ETSC in a deemed section 351 exchange. See section 1361(b)(3)(C)(i); §1.1361-5(b)(1)(i). A corporation formed for a business purpose is a taxpayer separate from its shareholder(s). See generally Moline Properties v. Commissioner, 319 U.S. 436 (1943). As a result of the ETSC corporate subsidiary's status as a new C corporation with no prior taxable year (rather than, for example, as a successor under section 381(a) of the Code), commenters have noted that the ETSC corporate subsidiary lacks any historical method of accounting from which to change. Compare §1.446-1(e)(1) (providing that a taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return) with section 381(c)(4) (providing that, in general, a successor corporation must use the method of accounting used by the predecessor corporation as of the date of the section 381(a) transaction).

Notwithstanding those observations of the law, commenters have requested that the final regulations extend the section 481(d) inclusion period to an accrual method ETSC corporate subsidiary that operated as a cash method QSub of a cash method S corporation prior to the revocation of the parent's S election. These commenters highlighted that, in the deemed section 351 exchange required by section 1361(b)(3)(C)(i) and §1.1361-5(b)(1)(i) that results from the revocation of the parent's S election, the accounts receivable of a former cash method QSub would be deemed transferred to the accrual method ETSC corporate subsidiary with a zero basis. See generally Raich v. Commissioner, 46 T.C. 604 (1966) (holding that trade accounts receivable of a cash method transferor received by an accrual basis transferee in a section 351 exchange had a zero basis). Therefore, the ETSC corporate subsidiary

would recognize income as it collects amounts on the transferred receivables. In the case where the ETSC corporate subsidiary collects the entire amount of the transferred receivables during its first taxable year, commenters contended that the ETSC corporate subsidiary's inability to include the amount received over the six-year section 481(d) inclusion period would inappropriately disadvantage the former QSub as compared to its former S corporation parent.

The Treasury Department and the IRS understand the commenters' concerns regarding the statutorily limited application of section 481(d) and observe that the commenters' request is not unique to the application of section 481(d), but rather addresses the longstanding treatment of former S corporations and QSubs under section 481 with regard to a deemed section 351 exchange. Throughout the nearly 25-year period since the 1996 enactment of the QSub provisions under section 1361, section 481(a)(2) and any inclusion period for a 481 adjustment have not applied with respect to former QSubs. See section 1308 of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1755, 1782-3 (August 20, 1996). See also Rev. Proc. 97-27, 1997-1 C.B. 680, section 5.02(3)(a) (providing a four-year amortization period solely to taxpayers that have a 481 adjustment); Rev. Proc. 2015-13, 2015-5 I.R.B. 419, section 7.03(1) (same). After considering the commenters' analysis and the explicit reference in section 481(d) to section 481(a)(2), the Treasury Department and the IRS have determined that section 481(d) does not apply to ETSC corporate subsidiaries, but rather maintains the longstanding application of section 481(a) solely to taxpayers that make an accounting method change. Accordingly, there is no

authority under section 481(d) to extend the section 481(d) inclusion period to ETSC corporate subsidiaries.

Commenters also contended that the Treasury Department and the IRS could override the limited scope of section 481(d) through special QSub regulations issued under the authority provided by section 481(c), which, in the case of a taxpayer making an accounting method change, authorizes regulations permitting a taxpayer to take any 481 adjustment into account in computing taxable income for the taxable year or years permitted under such regulations. For example, commenters suggested that the final regulations permit an accrual method ETSC corporate subsidiary to elect to treat the assets received (and liabilities assumed) by the ETSC corporate subsidiary in the deemed section 351 exchange as though the subsidiary had owned such assets (and had such liabilities) in a prior taxable year, thereby creating an accounting method change upon the revocation. However, this approach contradicts the explicit text of section 1362(b)(3)(C)(i), which provides that, “[f]or purposes of this title” (that is, for purposes of all of the provisions of the Code), an ETSC corporate subsidiary “shall be treated as a new corporation.”

In the alternative, commenters suggested that the final regulations could permit taxpayers to treat the assets received (and liabilities assumed) by an ETSC corporate subsidiary as though still owned by the former S corporation on the date on which the former S corporation becomes an ETSC. Under this approach, the ETSC’s 481 adjustment would be computed as if the ETSC owned such assets and was subject to such liabilities. For support, these commenters highlighted anti-abuse regulations issued under section 263A of the Code (UNICAP anti-abuse regulations) that utilized

this alternative approach. See §1.263A-7(c)(4)(ii) (providing an anti-abuse rule regarding the use of section 351 exchanges to avoid application of section 263A). However, the UNICAP anti-abuse regulations were issued under the authority of section 263A(h)(1) rather than the authority granted the Secretary under section 481(c). See 52 FR 10052, 10059 (March 30, 1987). Section 263A(h)(1) requires the Secretary to "prescribe rules to carry out the purpose of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of this section." Section 263A(j)(1).

The Treasury Department and the IRS have considered the commenters' suggested approaches for extending the section 481(d) inclusion period to ETSC corporate subsidiaries but have determined that section 481(c) would not support either approach. Section 481(c) and §1.481-1(c)(2) provide the general rule that the 481 adjustment is taken into account in computing taxable income in the year of change, unless the Commissioner prescribes a different taxable year or years to take the 481 adjustment into account under §§1.446-1(e)(3) and 1.481-4. Any regulations issued under section 481(c) can apply only "[i]n the case of any change described in [section 481](a)" with regard to "adjustments required by [section 481](a)(2)." As acknowledged by the commenters, section 481(a) does not apply to an ETSC corporate subsidiary because such entity is newly formed and therefore could not have had a prior accounting method to potentially change.

Based on the foregoing, the final regulations do not adopt either of the commenters' alternative suggestions or provide any inclusion period for ETSC corporate subsidiaries under section 481. The Treasury Department and the IRS, however, note

that TCJA amendments to section 448(c) of the Code have significantly expanded the applicability of the cash method to C corporations, including ETSC corporate subsidiaries. As amended by section 13102(a) of the TCJA (131 Stat. 2054, 2102-3), section 448(c) provides that a C corporation may use the cash method if the corporation has average annual gross receipts not exceeding $25 million (adjusted for inflation) for its three prior taxable years. Prior to the TCJA, the gross receipts threshold under section 448(c) was $5 million. As a result, fewer ETSC corporate subsidiaries will be required to adopt the accrual method as their permissible method of accounting for their first tax return than if the section 448(c) gross receipts threshold had not been increased from $5 million to $25 million.

III. Comments Regarding the Post-Termination Transition Period

The last sentence of §1.1377-2(b), as in effect prior to the effective date of these final regulations (no-newcomer rule), limited the special treatment provided under section 1371(e)(1) (with respect to distributions of money during a corporation's PTTP) solely to those shareholders who were shareholders of the corporation at the time that it terminated or revoked its S election (collectively, legacy shareholders). Because the rules pertaining to the PTTP and to the ETSC period serve a similar objective of easing the transition from S corporation to C corporation status, the Treasury Department and the IRS determined that the rules regarding newcomers (that is, non-legacy shareholders) should be consistent. See preamble to the proposed regulations, Explanation of Provisions, part IV. Therefore, based on the rationale for rejecting a no-newcomer rule with respect to the ETSC period, as set forth in part II.A of the Explanation of Provisions of the preamble to the proposed regulations, the Treasury

Department and the IRS determined that such a rule should also not apply with respect to the PTTP and proposed the removal of the no-newcomer rule in §1.1377-2(b). See id.

A. Reliance on the §1.1377-2(b) no-newcomer rule

One commenter expressed concern that elimination of the no-newcomer rule in §1.1377-2(b) could alter bargained-for economic results if a legacy shareholder had transferred less than all of its shares prior to November 7, 2019 (that is, the publication date of the proposed regulations) or after that date but pursuant to a binding agreement entered into before that date. In particular, the commenter contended that legacy shareholders who transferred less than all of their shares would have expected that only legacy shareholders could receive distributions of AAA during the PTTP, and perhaps even during the ETSC period. According to the commenter, this expectation would have reduced the bargained-for price for the transferred shares to reflect the tax benefit of the future tax-free distributions.

The commenter provided an example in which a sole shareholder of an ETSC sold 40 percent of its stock to a third-party. The sale price was set prior to November 7, 2019, and the parties assumed that the no-newcomer rule would limit distributions of AAA to the legacy shareholder during the PTTP, and that a similar rule would apply during the ETSC period. Under the proposed elimination of the no-newcomer rule in §1.1377-2(b), however, the newcomer, and not the legacy shareholder, would be eligible to receive 40 percent of any AAA distributed during the PTTP or ETSC period. The commenter observed that the newcomer's accession to a 40 percent interest in the corporation's AAA during the PTTP and ETSC period amounts to a transfer of a tax

benefit from the legacy shareholder to the newcomer for no consideration, contrary to the parties' expectations. Therefore, the commenter recommended that the final regulations include an additional transition rule. Under this rule, if shares of a former S corporation were transferred to a newcomer pursuant to a binding agreement entered into before the applicability date of the final regulations, then, except upon unanimous agreement of current shareholders of a corporation that are legacy shareholders, the no-newcomer rule would apply during the PTTP, and a similar rule would apply during the ETSC period.

The Treasury Department and the IRS understand the concern underlying the commenter's recommendation. However, the Treasury Department and the IRS intended the applicability date provisions in the proposed regulations, and as adopted in these final regulations, to afford corporations transition flexibility in applying §1.1377-2(b) with regard to the PTTP. Section 1.1377-2(b), as revised by the final regulations to eliminate the no-newcomer rule for special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period applies to a corporation's taxable years beginning after the date of publication of the final regulations. In the case of a corporation using the calendar year as its annual accounting period, newcomers are not entitled to receive distributions of AAA before January 1, 2021, unless the corporation chooses to apply §1.1377-2(b) before January 1, 2021. Corporations to which the commenter's transition rule would have applied generally will thus have completed their PTTPs prior to the applicability of §1.1377-2(b). Distributions of AAA during those PTTPs would have been limited to legacy shareholders. Additionally, the commenter's proposed transition rule

would add complexity in administering these rules. Accordingly, the Treasury Department and the IRS have determined that the applicability date provisions, as set forth in the proposed regulations and adopted in these final regulations, balance appropriately the protection of legacy taxpayers' expectations with the goal of the Treasury Department and the IRS to minimize complexity and administrative difficulties for S corporations, their shareholders, and the IRS.

With regard to the ETSC period, as discussed in part II.A of the Explanation of Provisions of the preamble to the proposed regulations, section 1371(f) does not contain a no-newcomer rule similar to §1.1377-2(b), and the Treasury Department and the IRS have concluded that it is inappropriate to adopt one. Corporations may have applied a similar analysis of section 1371(f) and made distributions of AAA to newcomers during their respective ETSC periods. Providing an alternate rule in these final regulations for the ETSC period could unexpectedly alter taxpayers' bargained-for economic results. Therefore, the Treasury Department and the IRS have determined that the best way to address this situation is to allow but not require corporations to apply the final regulations addressing distributions made during the ETSC period to taxable years beginning on or before the date that these final regulations are published in the Federal Register.

B. Consideration of request for an additional 120-day PTTP

A commenter recommended that the final regulations provide a new 120-day PTTP that would begin on the applicability date of the final regulations. The commenter noted that this new PTTP would create an opportunity for any C corporation with undistributed AAA that expired at the end of its PTTP to restore and distribute such AAA

pursuant to section 1371(e)(1) and §1.1377-2. The commenter contended that the elimination of the no-newcomer rule only for terminations that occur after the issuance of the proposed regulations disadvantages corporations that terminated their S election more than one year prior to issuance of the proposed regulations, as compared to corporations that terminated their S election after the issuance of the proposed regulations.

The Code sets forth a statutory definition of the PTTP that includes detailed limits on its duration. Specifically, section 1377(b)(1)(A), (B), and (C) provide three separate durations for the PTTP, the respective applicability of which depends upon particular events. While the Treasury Department and the IRS acknowledge the concerns raised by the commenter, the final regulations do not adopt the commenter's recommendation because (i) section 1377(b) provides specific, detailed, and unambiguous guidance on the duration of a PTTP, and (ii) the recommended revision to §1.1377-2 exceeds the scope of the authority granted to prescribe regulations under sections 1371 or 1377.

IV. Consideration of Comment Regarding Treatment of ETSC Status and AAA as Section 381 Items

In the case of certain asset acquisitions, section 381(a) generally requires the acquiring corporation to succeed to and take into account the tax items described in section 381(c) of the distributor or transferor corporation. See section 381(a) (describing distributions to which section 332 of the Code applies and transfers to which section 361 of the Code applies that are carried out in connection with certain reorganizations described in section 368(a)(1) of the Code); section 381(c)

(enumerating tax items of the distributor or transferor corporation that the acquiring corporation succeeds to and takes into account under section 381(a)).

A commenter requested that the final regulations confirm that ETSC status and AAA constitute tax items that an acquiring corporation would succeed to or take into account under section 381(a). The Treasury Department and the IRS have considered the issue raised by the commenter but have determined that further study would be required to promulgate the appropriate rule. In addition, the Treasury Department and the IRS have concluded that this issue exceeds the scope of the final regulations because whether AAA constitutes a tax item to which a successor may succeed under section 381 is not limited to the ETSC context. Therefore, the final regulations do not address the commenter's request.

Applicability Dates

These regulations generally apply to taxable years beginning after **[INSERT DATE OF PUBLICATION IN FEDERAL REGISTER]**. See §§1.481-6(b), 1.1371-1(e), 1.1371-2(d), and 1.1377-3(c). However, a corporation may choose to apply the rules set forth in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].** If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

In addition, a corporation generally may choose to not apply the no-newcomer rule in §1.1377-2(b) to taxable years beginning on or before **[INSERT DATE OF**

PUBLICATION IN THE FEDERAL REGISTER] and with respect to which the period described in section 6501(a) as applied to that corporation has not expired. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must adopt §§1.481-5, 1.1371-1, 1.1371-2 (if an ETSC), and §1.1377-2(b) in their entirety and continue to apply those rules in their entirety for the corporation's subsequent taxable years.

Special Analyses

These final regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

I. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. Notwithstanding this certification, the Treasury Department and the IRS provided such an analysis in the notice of proposed rulemaking preceding these final regulations (see 84 FR 60011) and received no comments on the impact that the proposed regulations would have on small entities. This certification is based on the fact that the amount of time necessary to report the required information will be minimal in that it requires ETSCs to provide information already required to be collected by previously existing statutory and regulatory requirements. Accordingly, the Secretary

certifies that these regulations will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small businesses. No comments were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

II. Paperwork Reduction Act

These final regulations do not require collection of any new or additional information pursuant to the Paperwork Reduction Act (44 U.S.C. 3501 et seq.). Nevertheless, the Treasury Department and the IRS provided such an analysis in the notice of proposed rulemaking preceding these final regulations. See 84 FR 60011.

III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2020, that threshold is approximately $156 million. This final rule does not include any mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

IV. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial, direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Drafting Information

The principal authors of these final regulations are Margaret Burow and Michael Gould of the Office of Associate Chief Counsel (Passthroughs and Special Industries) and Aglaia Ovtchinnikova of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in the development of the final regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order for §1.481-6 to read in part as follows:

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

Section 1.481-6 is also issued under 26 U.S.C. 481.

* * * * *

§1.316-2 [Amended]

Par. 2. Section 1.316-2 is amended by removing "consist only of money and" from the second sentence of paragraph (b).

§1.481-5 [Redesignated as §1.481-6]

Par. 3. Section 1.481-5 is redesignated as §1.481-6.

Par. 4. Section 1.481-5 is added to read as follows:

§1.481-5 Eligible terminated S corporation.

(a) Scope. Section 481(d)(2) of the Internal Revenue Code (Code) and this section provide rules relating to the qualification of a corporation as an eligible terminated S corporation (ETSC). Paragraph (b) of this section sets forth the requirements a corporation must meet to qualify as an ETSC. Paragraph (c) of this section describes certain transfers and other events that are disregarded for purposes of determining whether a corporation qualifies as an ETSC, as well as the treatment of revocations for which the effective date is the first day of the taxable year during which the revocation is made. Paragraph (d) of this section contains examples illustrating the rules of this section.

(b) ETSC qualification. For a C corporation to qualify as an ETSC, it must satisfy the following requirements:

(1) The corporation must have been an S corporation on December 21, 2017;

(2) During the 2-year period beginning on December 22, 2017, the corporation must have made a valid revocation of its S election under section 1362(d)(1) and the regulatory provisions in this part under section 1362 of the Code (revocation); and

(3) Except as provided in paragraph (c) of this section, the owners of the shares of stock of the corporation must be the same (and in identical proportions) on both:

(i) December 22, 2017; and

(ii) The day on which the revocation is made.

(c) Special rules--(1) Certain disregarded events. The following events are disregarded for purposes of determining whether the requirement in paragraph (b)(3) of this section is satisfied:

(i) Transfers of stock between a shareholder and that shareholder's trust treated as wholly owned by that shareholder under subpart E of subchapter J of chapter 1 of the Code;

(ii) Transfers of stock between a shareholder and an entity owned by that shareholder that is disregarded as separate from its owner under §301.7701-2(c)(2)(i) of the Procedure and Administration Regulations;

(iii) An election by a shareholder trust to be treated as part of a decedent's estate under section 645 of the Code or the termination of an election under that section;

(iv) A change in the status of a shareholder trust from one type of eligible S corporation shareholder trust described in section 1361(c)(2)(A) of the Code to another type of eligible S corporation shareholder trust; for example, a trust to which the shares of stock were transferred pursuant to the terms of a will (testamentary trust) described in section 1361(c)(2)(A)(iii) that elects to become an electing small business trust described in section 1361(c)(2)(A)(v) and (e); and

(v) A transaction that includes more than one of the events described in this paragraph (c)(1).

(2) Certain revocations. For purposes of paragraphs (b)(2) and (b)(3)(ii) of this section, a revocation with an effective date that is the first day of the taxable year during which the revocation is made pursuant to section 1362(d)(1)(C)(i) may be treated as having been made on the day the revocation was made or on the effective date of the revocation.

(d) Examples. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (d), as of December 1, 2017, X is a calendar year S corporation with 100 shares of stock outstanding that is owned equally by unrelated individuals A and B. Pursuant to section 1362(d)(1) and §§1.1362-2 and 1.1362-6, X made a valid revocation of its S election on March 15, 2019, effective on January 1, 2019. X treats the revocation as having been made on March 15, 2019, for purposes of paragraphs (b)(2) and (b)(3)(ii). At all times, X has a single class of stock outstanding. The examples describe all relevant transactions involving the X stock from December 1, 2017, until March 15, 2019.

(1) Example 1--(i) Facts. On June 5, 2018, A contributed 20 of its shares of X stock to Y, a wholly owned limited liability company that is disregarded as an entity separate from A pursuant to §301.7701-2(c)(2)(i). On June 14, 2018, A contributed all of its interest in Y to Trust, which was a revocable trust treated as a wholly owned grantor trust of A pursuant to sections 671 and 676 of the Code. On December 27, 2018, B sold 10 shares of its X stock to C, an unrelated person.

(ii) Analysis. X is an ETSC if it satisfies the requirements of paragraph (b) of this section.

(A) S corporation. X was an S corporation on December 21, 2017. Therefore, X satisfies the requirement of paragraph (b)(1) of this section.

(B) Date of revocation. X made a valid revocation of its S election pursuant to section 1362(d)(1) on March 15, 2019, which is during the two-year period specified in paragraph (b)(2) of this section. Therefore, X satisfies the requirement of paragraph (b)(2) of this section.

(C) Ownership. For purposes of the requirement in paragraph (b)(3) of this section, the relevant dates are: December 22, 2017, and March 15, 2019 (the date X made a revocation of its S corporation status).

(1) A's ownership interest. As of December 22, 2017, A owned 50 shares of the outstanding shares of X stock. On June 5, 2018, A contributed 20 of its shares of X stock to Y (Transfer). On June 14, 2018, A contributed all of its interest in Y to Trust (Contribution). Both the Transfer and the Contribution are disregarded for purposes of determining whether the requirement of paragraph (b)(3) of this section is satisfied. See paragraphs (c)(2) and (1) of this section, respectively. Therefore, A owns 50 shares of the outstanding stock of X on March 15, 2019.

(2) B's ownership interest. As of December 22, 2017, B owned 50 shares of the outstanding shares of X stock. On December 27, 2018, B sold 10 shares to C. Therefore, B owns 40 shares of the outstanding stock of X on March 15, 2019.

(3) C's ownership interest. As of December 22, 2017, C owned no shares of X stock. On December 27, 2018, C purchased 10 shares from B. Therefore, C owns 10 shares of the outstanding stock of X on March 15, 2019.

(4) Failure to satisfy the requirement in paragraph (b)(3) of this section. As described in paragraphs (d)(1)(ii)(C)(2) and (3) of this section, B's and C's interest in X were not in the same proportions on December 22, 2017, and March 15, 2019. Therefore, X does not satisfy the requirement of paragraph (b)(3) of this section and does not qualify as an ETSC.

(iii) Restoration of interests prior to end of PTTP. If C transferred its shares of X stock back to B on February 1, 2019, then on December 22, 2017, and March 15, 2019, A and B will have owned 50 shares of the outstanding stock of X. Under these facts, X satisfies the requirement of paragraph (b)(3) of this section and qualifies as an ETSC.

(2) Example 2--(i) Facts. The facts are the same as in paragraph (d)(1)(i) of this section, except that B sold 10 shares of its X stock to C on December 18, 2017, in addition to the sale of 10 shares of X stock on December 27, 2018.

(ii) Analysis. The analysis in paragraph (d)(1)(ii)(A) and (B) of this section remains the same regarding the requirements of paragraph (b)(1) and (2) of this section. With respect to the requirement of paragraph (b)(3) of this section, on December 22, 2017, A owned 50%, B owned 40%, and C owned 10% of the outstanding stock of X. As in paragraph (d)(1)(ii)(C)(1) of this section, the Transfer and the Contribution are disregarded for purposes of determining whether the requirement of paragraph (b)(3) of this section is satisfied. Therefore, on March 15, 2019, A owned 50% (50 shares), B owned 30% (30 shares), and C owned 20% (20 shares) of the outstanding shares of X. Even though A, B, and C owned shares of X on December 22, 2017, B's and C's proportionate ownership interest of X stock was not the same on December 22, 2017, and March 15, 2019. Therefore, X does not satisfy the requirement of paragraph (b)(3) of this section and does not qualify as an ETSC.

(3) Example 3--(i) Facts. The facts are the same as in paragraph (d)(1)(i) of this section, except that X made a valid revocation of its S election on November 1, 2019, effective on January 1, 2020.

(ii) Analysis. The analysis in paragraph (d)(1)(ii)(A) through (C) of this section remains the same regarding the requirements of paragraph (b)(1) through (3) of this section, except that the relevant dates are: December 22, 2017, and November 1, 2019 (the date X made a revocation of its S corporation status). Although the effective date of X's revocation of its S election (January 1, 2020) occurs after the conclusion of the two-year period specified in paragraph (b)(2) of this section, it is irrelevant for purposes of determining whether the requirements of paragraph (b)(2) and (3) of this section are satisfied.

Par. 5. Section 1.481-6 is revised to read as follows:

§1.481-6 Effective dates; applicability dates.

(a) Sections 1.481-1, 1.481-2, 1.481-3, and 1.481-4. Sections 1.481-1, 1.481-2, 1.481-3, and 1.481-4 are effective for Consent Agreements signed on or after December 27, 1994. For Consent Agreements signed before December 27, 1994, see §§1.481-1, 1.481-2, 1.481-3, 1.481-4, and 1.481-5 as contained in 26 CFR part 1, revised as of April 1, 1995.

(b) Section 1.481-5. Section 1.481-5 applies to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. However, a corporation may choose to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If a corporation makes the choice described in the previous sentence, the corporation must continue to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

Par. 6. Section 1.1362-2 is amended by adding paragraph (a)(2)(iii) to read as follows:

§1.1362-2 Termination of election.

(a) * * *

(2) * * *

(iii) Applicability of section 7503. With respect to a revocation made under paragraph (a)(2) of this section, see section 7503 (addressing time for performance of acts where the last day occurs on a Saturday, Sunday, or legal holiday). This paragraph (a)(2)(iii) applies to revocations made under paragraph (a)(2) of this section effective after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A corporation may apply this paragraph (a)(2)(iii) retroactively to a revocation made by the corporation under paragraph (a)(2) of this section effective on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

* * * * *

Par. 6. Sections 1.1371-1 and 1.1371-2 are added to read as follows:

§1.1371-1 Distributions of money by an eligible terminated S corporation.

(a) Scope and definitions--(1) Scope. This section provides rules relating to qualified distributions and distributions to which section 301 of the Internal Revenue Code (Code) applies during each taxable year of the ETSC period, including the taxable year in which the ETSC period ends. If an ETSC does not make any qualified distributions during a taxable year, then no distribution by the ETSC is governed by section 1371(f) of the Code or this section. Paragraph (a)(2) of this section contains definitions that apply for purposes of this section. Paragraph (b) of this section contains rules regarding the characterization of a qualified distribution. Paragraph (c) of this section contains rules regarding the characterization of any excess qualified distribution and non-qualified distribution during each taxable year of the ETSC period, including the taxable year in which the ETSC period ends. Paragraph (d) of this section contains

examples illustrating the rules of this section. Paragraph (e) of this section contains the applicability date of this section.

(2) Definitions. The following definitions apply for purposes of this section--

(i) AAA. The term AAA means the accumulated adjustments account, within the meaning of section 1368(e)(1)(A) of the Code and §1.1368-2(a)(1).

(ii) AAA ratio. Except as provided in this paragraph or paragraph (b)(3)(iv) of this section, the term AAA ratio means the fraction of which the numerator is historical AAA and the denominator is the sum of historical AAA and historical AE&P. Notwithstanding the preceding sentence, if the AE&P of the ETSC is less than or equal to zero as of the beginning of a taxable year, then the AAA ratio is one for such year and for all subsequent taxable years of the ETSC period.

(iii) AE&P. The term AE&P means earnings and profits described in section 316(a)(1) of the Code.

(iv) AE&P ratio. Except as provided in this paragraph or paragraph (b)(3)(iv) of this section, the term AE&P ratio means the fraction of which the numerator is historical AE&P, and the denominator is the sum of historical AAA and historical AE&P. Notwithstanding the preceding sentence, if the AE&P of the ETSC is less than or equal to zero as of the beginning of a taxable year, then the AE&P ratio is zero for such year and all subsequent taxable years of the ETSC period.

(v) CE&P. The term CE&P means earnings and profits that are described in section 316(a)(2).

(vi) ETSC. The term ETSC means an eligible terminated S corporation, within the meaning of section 481(d) of the Code and §1.481-5.

(vii) ETSC period. In general, the term ETSC period means any taxable year, or portion thereof, of an ETSC beginning on the first day after the post-termination period within the meaning of section 1377(b)(1)(A) of the Code and ending on the date on which the ETSC's AAA balance is zero. Additionally, an ETSC does not have an ETSC period if the ETSC's AAA balance is not greater than zero at the end of its post-termination transition period. See §1.1371-2 for rules governing the impact of a post-termination period, within the meaning of section 1377(b)(1)(B), on the ETSC period.

(viii) Excess qualified distribution. The term excess qualified distribution means the portion of a qualified distribution that is not characterized pursuant to paragraph (b)(2) or (3) of this section.

(ix) Historical AAA. The term historical AAA means the AAA of the ETSC as of the beginning of the day on which the revocation of an election under section 1362(a) of the Code is effective pursuant to section 1362(d)(1).

(x) Historical AE&P. The term historical AE&P means the AE&P of the ETSC as of the beginning of the day on which the revocation of an election under section 1362(a) is effective pursuant to section 1362(d)(1). For purposes of the preceding sentence, if the ETSC's historical AE&P is less than zero, then the historical AE&P is treated as zero.

(xi) Non-qualified distribution. The term non-qualified distribution means a distribution that is not a qualified distribution and to which section 301 applies.

(xii) Qualified distribution. The term qualified distribution means a distribution of money by an ETSC during the ETSC period to which, absent the application of section 1371(f) and this section, section 301 would apply. However, if paragraph (d)(2)(i) of this

section applies to the ETSC, then a qualified distribution to a non-legacy shareholder is treated as a non-qualified distribution.

(b) Characterization of qualified distribution--(1) In general. Paragraph (b)(2) of this section provides rules regarding the determination of the amount of a qualified distribution that is sourced from AAA and the corollary effects of such a characterization. Paragraph (b)(3) of this section provides rules regarding the determination of the amount of a qualified distribution that is sourced from AE&P and the corollary effects of such a characterization. Paragraph (b)(4) of this section provides rules regarding the characterization of an excess qualified distribution as a separate qualified distribution. The rules in paragraphs (b)(2) through (4) of this section are applied before the application of paragraph (c) of this section.

(2) Distribution of AAA--(i) Amount. The portion of a qualified distribution that is sourced from an ETSC's AAA is equal to the lesser of:

(A) The product of the qualified distribution and the AAA ratio; and

(B) The ETSC's AAA immediately before the qualified distribution.

(ii) Reduction or elimination of ETSC's AAA. The ETSC's AAA is reduced by the amount of the distribution described in paragraph (b)(2)(i) of this section. If, with respect to a qualified distribution, the amount described in paragraph (b)(2)(i)(A) of this section equals or exceeds the amount described in paragraph (b)(2)(i)(B) of this section, then the rules in this paragraph (b) do not apply to any subsequent distributions by the ETSC. Instead, the subsequent distributions are treated in the manner provided in paragraph (c) of this section.

(iii) Effect on the shareholder. The amount described in paragraph (b)(2)(i) of this section is applied against and reduces the shareholder's adjusted basis of the shares of stock with respect to which the distribution is made under the principles of section 301(c)(2). If the application of the amount described in paragraph (b)(2)(i) of this section would result in a reduction of basis that exceeds the shareholder's adjusted basis of any share of stock with respect to which the distribution is made, such excess is treated as gain from the sale or exchange of property. The reduction of the shareholder's basis described in this paragraph with respect to a qualified distribution occurs prior to the application of paragraph (c) of this section to the excess qualified distribution, if any, with respect to such qualified distribution.

(3) Distribution of AE&P--(i) Amount. This paragraph (b)(3) applies if an ETSC's AE&P ratio is greater than zero. If this paragraph (b)(3) applies, the portion of a qualified distribution that is sourced from the ETSC's AE&P is equal to the lesser of:

(A) The product of the qualified distribution and the AE&P ratio, and

(B) The ETSC's AE&P immediately before the qualified distribution. For purposes of the preceding sentence, if the ETSC's AE&P immediately before the qualified distribution is less than zero, then the ETSC's AE&P is treated as zero.

(ii) Effect on ETSC's AE&P. The ETSC's AE&P is reduced, as described in section 312(a)(1), by the amount of the distribution described in paragraph (b)(3)(i) of this section. The AE&P reduction described in this paragraph occurs prior to the application of paragraph (c) of this section, even if a distribution to which paragraph (c) of this section applies (regarding excess qualified distributions and non-qualified

distributions) occurs earlier in time than the qualified distribution to which this paragraph applies.

(iii) Effect on the shareholder. The amount of the qualified distribution that is sourced from the ETSC's AE&P described in paragraph (b)(3)(i) of this section is included in the gross income of the shareholder as a dividend under section 301(c)(1).

(iv) Adjustment to the AAA ratio and the AE&P ratio. After the application of paragraph (b)(3)(ii) of this section, if the ETSC's AE&P is zero and the ETSC's AAA is greater than zero, then the ETSC's AAA ratio is one and the ETSC's AE&P ratio is zero for all subsequent qualified distributions during:

(A) That taxable year; and

(B) All subsequent taxable years of the ETSC period.

(4) Excess qualified distribution treated as a separate qualified distribution--(i) In general. After the application of paragraph (b)(2)(ii) of this section with respect to a qualified distribution, if the ETSC has any remaining AAA, then any amount of excess qualified distribution, with respect to such qualified distribution, is treated as a separate qualified distribution and is analyzed pursuant to paragraph (b) of this section.

(ii) No change in characterization of previously characterized portion of qualified distribution. Paragraph (b)(4)(i) will not change the characterization of any portion of a qualified distribution that was previously characterized pursuant to paragraphs (b)(2) and (3) of this section and will reflect the application of paragraphs (b)(2) and (3) of this section to the portion of the qualified distribution previously characterized.

(c) Characterization of excess qualified distribution and non-qualified distributions. After the application of paragraph (b), the excess qualified distributions, if

any, and non-qualified distributions, if any, are treated in the manner provided in sections 301(c) and 316.

(d) Examples. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (d), X is a calendar year S corporation with a single share of stock outstanding. A, an individual, purchased its share of X stock prior to December 22, 2017, and, except as otherwise indicated, never contributed any amounts to X's capital. A remained the sole shareholder of X when X made a valid revocation on March 15, 2018, pursuant to section 1362(d)(1) and §§1.1362-2 and 1.1362-6, of its S election and when that revocation became effective on January 1, 2018. X qualified as an ETSC pursuant to §1.481-5(b) and its ETSC period began on January 1, 2019. Additionally, X did not make any distributions during its post-termination transition period, within the meaning of section 1377(b)(1)(A). Furthermore, A remains the sole shareholder of X at the time of the distribution(s) described.

(1) Example 1. Historical AE&P is zero. (i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $0. During 2018, X had $300 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $300, and A's adjusted basis in its share of X stock is $460. During 2019, the only distribution that X makes is a $60 distribution of money to A on December 27. X's CE&P during 2019 is $150, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $0. Therefore, X's AAA ratio is 1 ($100/($100 + $0)), and X's AE&P ratio is zero ($0/($100 + $0)).

(B) Characterization of distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $60 distribution on December 27, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) Analysis of qualified distribution--(1) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($60 x 1, or $60), and X's AAA immediately before the qualified distribution ($100). Therefore, $60 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $60 to $40. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $60 to $400.

(2) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($60 x 0, or $0), and X's AE&P immediately before the qualified distribution ($300). Therefore, $0 is sourced from AE&P.

(2) Example 2. Qualified distributions with both historical AAA and historical AE&P. (i) Facts. At the beginning of January 1, 2018, X had AAA of $200 and AE&P of $100. During 2018, X had $0 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $200 and AE&P of $100, and A's adjusted basis in its share of X stock is $500. During 2019, X makes a $90 distribution of money on February 9 and a $150 distribution of money on June 5. X's CE&P during 2019 is $500, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $200 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.67 ($200/($200 + $100)), and X's AE&P ratio is 0.33 ($100/($200 + $100)).

(B) Characterization of distributions. Pursuant to paragraph (a)(2)(xii) of this section, the $90 distribution on February 9, 2019, and the $150 distribution on June 5, 2019, are both qualified distributions because they are distributions of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) Analysis of qualified distributions--(1) February 9, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($90 x 0.67, or $60), and X's AAA immediately before the qualified distribution ($200). Therefore, $60 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $60 to $140. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $60 to $440.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the

product of the qualified distribution and the AE&P ratio ($90 x 0.33, or $30), and X's AE&P immediately before the qualified distribution ($100). Therefore, $30 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $30 to $70. Pursuant to paragraph (b)(3)(iii) of this section, the $30 distribution is characterized as a dividend.

(2) June 5, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($150 x 0.67, or $100), and X's AAA immediately before the qualified distribution ($140). Therefore, $100 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $100 to $40. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $100 to $340.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($150 x 0.33, or $50), and X's AE&P immediately before the qualified distribution ($70). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $20. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(3) Example 3. Limitation on amount characterized as AAA. (i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $300. During 2018, X had $280 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $580, and A's adjusted basis in its share of X stock is $450. During 2019, the only distribution that X makes is a $500 distribution of money to A on October 5. X's CE&P during 2019 is $150, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $300. Therefore, X's AAA ratio is 0.25 ($100/($100 + $300)), and X's AE&P ratio is 0.75 ($300/($100 + $300)).

(B) Characterization of distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $500 distribution on October 5, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) Analysis of qualified distribution--(1) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($500 x 0.25, or $125), and X's AAA immediately before the qualified distribution

($100). Therefore, $100 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $100 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $100 to $350.

(2) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($500 x 0.75, or $375), and X's AE&P immediately before the qualified distribution ($580). Therefore, $375 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $375 to $205. Pursuant to paragraph (b)(3)(iii) of this section, the $375 distribution is characterized as a dividend.

(D) Effect of qualified distribution on ETSC period. Pursuant to paragraph (a)(2)(vii) of this section, X's ETSC period ends because X's AAA balance is zero following the October 5, 2019 distribution.

(E) Analysis of excess qualified distribution--(1) Amount of excess qualified distribution. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $25, the portion of the qualified distribution ($500) not characterized pursuant to paragraph (b)(2) or (3) of this section ($100 AAA distribution + $375 AE&P distribution).

(2) Characterization of excess qualified distribution. Paragraph (b)(4) of this section does not apply to the excess qualified distribution because X's AAA balance is zero after the application of paragraph (b)(2)(ii) of this section (see paragraph (d)(3)(ii)(C)(1) of this section). Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to sections 301(c)(1) and 316, the $25 excess qualified distribution is sourced from CE&P.

(iii) Subsequent contribution. The facts are the same as paragraph (d)(3)(i) of this section, except that at the time of the October 5, 2019 distribution, A's adjusted basis in its X stock is $90. Further, on December 27, 2019, A contributes $100 to X in a transaction described in section 351(a). The analysis in paragraph (d)(3)(ii) of this section remains the same, except that, unlike the second to last sentence of paragraph (d)(3)(ii)(C)(1) of this section, A's basis in its X stock is reduced by $90 to $0 and pursuant to paragraph (b)(2)(iii) of this section, $10 is treated as gain from the sale or exchange of property. Additionally, as a result of the December 27, 2019 contribution of $100, A's basis in its X stock is increased by $100, so that at the end of 2019, A's basis in its X stock is $100.

(4) Example 4. Limitation on the amount characterized as AE&P. (i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $100. During 2018, X had CE&P of $(75) and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $25, and A's adjusted basis in its share of X stock is $500. During 2019, the only distributions that X makes are a $100 distribution of money to A on July 9 and a $40 distribution of money to A on September 27. X's CE&P during

2019 is $20, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.5 ($100/($100 + $100)), and X's AE&P ratio is 0.5 ($100/($100 + $100)).

(B) Analysis of July 9, 2019 distribution--(1) Characterization of distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $100 distribution on July 9, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(2) Analysis of qualified distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($100 x 0.5, or $50), and X's AAA immediately before the qualified distribution ($100). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $50. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $50 to $450.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($100 x 0.5, or $50), and X's AE&P immediately before the qualified distribution ($25). Therefore, $25 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $25 to $0. Pursuant to paragraph (b)(3)(iii) of this section, $25 of the distribution is characterized as a dividend.

(3) Recalculation of AAA and AE&P ratios. Pursuant to paragraph (b)(3)(iv) of this section, because the July 9, 2019 distribution caused X's AE&P to be reduced to zero, the AAA ratio is one and the AE&P ratio is zero for all subsequent qualified distributions during the 2019 taxable year and subsequent taxable years of the ETSC period.

(4) Excess qualified distribution--(i) Amount of excess qualified distribution. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $25, the amount of the qualified distribution ($100) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $25 AE&P distribution).

(ii) Characterization of excess qualified distribution as a separate qualified distribution. Pursuant to paragraph (b)(4) of this section, because X has AAA remaining

after characterizing the qualified distribution (see paragraph (d)(4)(ii)(B)(2)(i) of this section), the $25 excess qualified distribution is treated as a separate qualified distribution and is analyzed pursuant to paragraph (b) of this section.

(iii) Analysis of excess qualified distribution that is treated as a separate qualified distribution. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the excess qualified distribution and the AAA ratio ($25 x 1, or $25), and X's AAA immediately before the excess qualified distribution ($50). Therefore, $25 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $25 to $25. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $25 to $425. Pursuant to paragraph (b)(3)(i) of this section, because X's AE&P ratio is zero, paragraph (b)(3) of this section does not apply.

(C) Analysis of September 27, 2019 distribution--(1) Characterization of the distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $40 distribution on September 27, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(2) Analysis of qualified distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($40 x 1, or $40), and X's AAA immediately before the qualified distribution ($25) (see paragraph (d)(4)(ii)(B)(4)(iii) of this section). Therefore, $25 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $25 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $25 to $400.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, because X's AE&P ratio is zero, paragraph (b)(3) of this section does not apply.

(3) Excess qualified distribution--(i) Amount of excess qualified distribution. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $15, the portion of the qualified distribution ($40) not characterized pursuant to paragraph (b)(2) or (3) of this section ($25 AAA distribution + $0 AE&P distribution).

(ii) Excess qualified distribution not characterized as a separate qualified distribution. Pursuant to paragraph (b)(4) of this section, because X has AAA of $0 after characterizing the qualified distribution (see paragraph (d)(4)(ii)(C)(2)(i) of this section), the $15 excess qualified distribution is not treated as a separate qualified distribution.

(iii) Analysis of excess qualified distribution that is not treated as a separate qualified distribution. Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to sections 301(c)(1) and 316, the $15 excess qualified distribution is sourced from CE&P.

(5) Example 5. Distributions include non-qualified distributions. (i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $100. During 2018, X had $0 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $100, and A's adjusted basis in its X stock is $200. During 2019, X makes a $100 distribution of money on June 14; a $300 distribution of property on November 9; and a $200 distribution of money on December 18. X's CE&P during 2019 is $160, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA is $100 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.5 ($100/($100 + $100)), and X's AE&P ratio is 0.5 ($100/($100 + $100)).

(B) Characterization of distributions. Pursuant to paragraph (a)(2)(xii) of this section, the $100 distribution on June 14, 2019, and the $200 distribution on December 18, 2019, are both qualified distributions because they are distributions of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section. Pursuant to paragraph (a)(2)(xi) of this section, the $300 distribution of property on November 9, 2019, is a non-qualified distribution. Pursuant to paragraph (b)(1) of this section, the rules of paragraph (b)(2) through (b)(4) of this section apply to the qualified distributions before the rules of paragraph (c) of this section apply to the non-qualified distribution and any excess qualified distributions.

(C) Analysis of qualified distributions--(1) June 14, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($100 x 0.5, or $50), and X's AAA immediately before the qualified distribution ($100). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $50. Pursuant to paragraph (b)(2)(iii) of this section, on June 14, 2019, A's basis in its X stock is reduced by $50 to $150.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($100 x 0.5, or $50), and X's AE&P immediately before the qualified distribution ($100). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $50. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(iii) Amount of excess qualified distribution. The amount of the excess qualified distribution is $0, the amount of the qualified distribution ($100) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $50 AE&P distribution).

(2) December 18, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($200 x 0.5, or $100), and X's AAA immediately before the qualified distribution ($50). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A must determine its basis as of December 18, 2019, in order to determine the consequences of receiving the $50 AAA distribution. Because the non-qualified distribution on November 9, 2019, which precedes the December 18, 2019 qualified distribution, could have the effect of reducing A's basis, any effect on A's basis from that non-qualified distribution must be analyzed prior to determining the effect of the December 18, 2019 distribution of AAA on A's basis. See paragraphs (d)(5)(ii)(D)(3) and (4) of this section. Pursuant to paragraph (a)(2)(vii) of this section, X's ETSC period ends because X's AAA balance is zero following the December 18, 2019 distribution.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($200 x 0.5, or $100), and X's AE&P immediately before the qualified distribution ($50). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $0. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(iii) Amount of excess qualified distribution. The amount of the excess qualified distribution is $100, the amount of the qualified distribution ($200) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $50 AE&P distribution).

(D) Analysis of non-qualified and excess qualified distributions--(1) In general. The $300 non-qualified distribution on November 9, 2019, and the $100 excess qualified distribution on December 18, 2019, are treated in the manner provided in section 301(c).

(2) Allocation of CE&P. Pursuant to section 316 and §1.316-2, X's CE&P is allocated proportionately among the excess qualified and the non-qualified distributions. Therefore, the portion of X's CE&P that is allocated to the November 9, 2019 distribution and the December 18, 2019 distribution is $120 ($160 CE&P x ($300 distribution / $400 total excess qualified and non-qualified distributions during 2019) and $40 ($160 CE&P x ($100 distribution / $400 total excess qualified and non-qualified distributions during 2019), respectively.

(3) November 9, 2019 distribution. Pursuant to paragraph (d)(5)(ii)(D)(2) of this section, $120 of the $300 distribution is characterized as a distribution of CE&P. Pursuant to paragraph (d)(5)(ii)(C)(2)(ii) of this section, the amount of X's AE&P available to allocate the November 9, 2019 distribution is $0. Therefore, the remaining $180 is characterized pursuant to section 301(c)(2) and (3). Pursuant to paragraph

(d)(5)(ii)(C)(1)(i) of this section, A's basis in its X stock prior to the November 9, 2019 distribution is $150. Therefore, $150 is applied against basis pursuant to section 301(c)(2) (reducing A's basis to $0) and $30 is treated as gain from the sale or exchange of property pursuant to section 301(c)(3).

(4) December 18, 2019 distribution--(i) Consequences of AAA distribution. As of December 18, 2019, A's basis in its X stock is $0. See paragraph (d)(5)(ii)(D)(3) of this section. Pursuant to paragraph (d)(5)(ii)(C)(2)(i) of this section, $50 of the distribution is characterized as a distribution of AAA. Because the amount of the distribution of AAA ($50) exceeds A's basis in its X stock ($0), pursuant to paragraph (b)(2)(iii) of this section, on December 18, 2019, $50 is treated as gain from the sale or exchange of property.

(ii) Characterization of excess qualified distribution. Pursuant to paragraph (d)(5)(ii)(C)(2)(iii) of this section, $100 of the December 18, 2019 distribution is an excess qualified distribution. Paragraph (b)(4) of this section does not apply to the excess qualified distribution because X's AAA balance is zero after the application of paragraph (b)(2)(ii) of this section (see paragraph (d)(5)(ii)(C)(2)(i) of this section. Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to paragraph (d)(5)(ii)(D)(2) of this section, $40 of the $100 excess qualified distribution is characterized as a distribution of CE&P. Pursuant to paragraph (d)(5)(ii)(D)(3) of this section, X's AE&P as the time of the December 18, 2019 distribution is $0. Therefore, the remaining $60 is characterized pursuant to section 301(c)(2) and (3). Pursuant to paragraph (d)(5)(ii)(D)(4)(i) of this section, A's basis in its X stock prior to characterization of the excess qualified distribution is $0. Therefore, $60 is treated as gain from the sale or exchange of property pursuant to section 301(c)(3).

(e) Applicability date. This section applies to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. However, a corporation may choose to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

§1.1371-2 Impact of Audit PTTP on ETSC Period.

(a) Definitions. For purposes of this section, the definitions used in §1.1371-1(a)(2) are applicable. Additionally, the following definitions apply for purposes of this section--

(1) Audit PTTP. The term audit PTTP means a post-termination transition period described in section 1377(b)(1)(B) of the Internal Revenue Code (Code).

(2) Initial PTTP. The term initial PTTP means a post-termination transition period described in section 1377(b)(1)(A).

(3) Intervening audit PTTP. The term intervening audit PTTP means an audit PTTP arising during the ETSC period.

(b) In general. If an intervening audit PTTP arises, the ETSC period immediately stops. Immediately following the end of the intervening audit PTTP, the ETSC period resumes if the ETSC's AAA balance is greater than zero. Otherwise, any subsequent distributions by the ETSC are treated in the manner provided in section 301(c) of the Code.

(c) Examples. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (c), X is a calendar year S corporation. A, an individual, purchased all of the outstanding shares of X in a single transaction at the same price per share prior to December 22, 2017, and was the sole shareholder of X at all times. Pursuant to section 1362(d)(1) of the Code and §§1.1362-2 and 1.1362-6, X made a valid revocation of its S election on March 15, 2019, that became effective on January 1, 2019. No amount distributed by X is an extraordinary dividend within the meaning of section 1059.

(1) Example 1. No ETSC period following initial PTTP. (i) Facts. At the beginning of January 1, 2019, X had AAA of $49,000 and AE&P of $2,000, and A's adjusted basis

in its shares of X stock was $50,000. During 2019, the only distribution that X made was a $49,000 distribution of money to A on March 13, 2019. X's CE&P during 2019 was $0, without regard to any diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Distribution during initial PTTP. Pursuant to sections 1371(e) and 1377(b)(1)(A), the $49,000 distribution of money on March 13, 2019, is characterized as a distribution of AAA because it was made during the initial PTTP.

(B) Effect on corporation. Pursuant to §1.1368-2(a)(3)(iii), X's AAA is reduced by $49,000 to $0. Following the initial PTTP, even if X satisfies the requirements of section 481(d)(2) of the Code and §1.481-5(b) to be an ETSC, X does not have an ETSC period because its AAA balance is zero at the end of its initial PTTP. Therefore, section 1371(f) of the Code and §1.1371-1 will not apply to any subsequent distributions by X.

(C) Effect on shareholder. Pursuant to section 1371(e)(1), A reduces its basis in its X stock by $49,000 to $1,000.

(2) Example 2. Intervening audit PTTP. (i) Facts. The facts are the same as the facts in paragraph (c)(1) of this section. On May 20, 2020, which is after X's initial PTTP, the IRS begins an audit of X's 2018 return. During the audit it is agreed that X overstated its advertising expense deduction by $10,000. On July 6, 2020, A signs a closing agreement whereby X's overstatement results in an additional tax on A's 2018 individual return. As a result, at the beginning of January 1, 2019, X had AAA of $59,000 ($49,000 + $10,000) and AE&P of $2,000. Additionally, at the beginning of January 1, 2019, A's adjusted basis in its shares of X stock was $60,000 ($50,000 + $10,000). During 2020, the only distribution X makes is a $6,000 distribution of money to A on September 1, 2020. X's CE&P during 2020 was $0, without regard to any diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Analysis of March 13, 2019 distribution. The treatment of the March 13, 2019, distribution is the same as described in paragraph (c)(1)(ii)(A) of this section, because the amount of the distribution ($49,000) does not exceed X's AAA balance at the beginning of January 1, 2019 ($59,000), and so the entirety of the $49,000 distribution is properly characterized as a distribution of AAA.

(1) Effect on corporation. As described in paragraph (c)(1)(ii)(B) of this section, X's AAA ($59,000 at the beginning of January 1, 2019) is reduced by $49,000 to $10,000. At the conclusion of X's initial PTTP (ending on December 31, 2019), X's AAA balance is $10,000. Pursuant to §1.1371-1(a)(2)(vii), X has an ETSC period. Therefore, section 1371(f) and §1.1371-1 will apply to any subsequent qualified distributions by X.

(2) Effect on shareholder. As described in paragraph (c)(1)(ii)(C) of this section, A reduces its basis in its X stock ($60,000 at the beginning of January 1, 2019) by $49,000 to $11,000.

(B) Intervening audit PTTP. Pursuant to section 1377(b)(1)(B), X enters an intervening audit PTTP that begins on July 6, 2020, and ends on November 2, 2020. The application of section 1371(f) and the regulations thereunder to distributions during the intervening audit PTTP is stopped. Instead, sections 1371(e) and 1377(b)(1)(B) and the regulations thereunder apply for the duration of the intervening audit PTTP. During the intervening audit PTTP, the only distribution X made is a $6,000 distribution of money to A on September 1, 2020. Pursuant to sections 1371(e) and 1377(b)(1)(B), the $6,000 distribution is characterized as a distribution of AAA because it was made during the intervening audit PTTP.

(1) Effect on corporation. Pursuant to §1.1368-2(a)(3)(iii), X's AAA is reduced by $6,000 to $4,000. Beginning on November 3, 2020, pursuant to §1.1371-1(a)(2)(vii), X's ETSC period resumes (after the intervening audit PTTP's conclusion) because its AAA balance is greater than zero.

(2) Effect on shareholder. Pursuant to section 1371(e)(1), A reduces its basis in its X stock by $6,000 to $5,000.

(C) ETSC period. Beginning on November 3, 2020, X's ETSC period resumes, and distributions of money are subject to section 1371(f) and the regulations thereunder until X's AAA balance is zero. For purposes of calculating each of X's AAA and AE&P ratios, X's historical AAA is $59,000 (at the beginning of January 1, 2019, which includes the $10,000 increase as a result of the July 6, 2020, closing agreement).

(d) Applicability date. This section applies to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. However, a corporation may choose to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety to taxable years that began on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must continue to apply the rules in §§1.481-5, 1.1371-1, and 1.1371-2 in their entirety for the corporation's subsequent taxable years.

Par. 7. Section 1.1377-2 is amended by removing the last sentence of paragraph (b).

Par. 8. Section 1.1377-3 is revised to read as follows:

§1.1377-3 Applicability dates.

(a) In general. Except as otherwise provided in this section, §§1.1377-1 and 1.1377-2 apply to taxable years of an S corporation beginning after December 31, 1996.

(b) Section 1.1377-1(a)(2)(iii) and related example. Section 1.1377-1(a)(2)(iii) and (c) Example 3 are applicable for taxable years beginning on and after May 14, 2002.

(c) Section 1.1377-2(b)--(1) In general. Except as provided in paragraph (c)(2) of this section, §1.1377-2(b) applies to taxable years beginning after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. For taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, see §1.1377-2(b) as contained in 26 CFR part 1, revised April 1, 2020.

(2) Taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A corporation may choose to apply §1.1377-2(b) to taxable years beginning on or before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and with respect to which the period described in section 6501(a) has not expired. If a corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently, and the corporation must adopt §§1.481-5, 1.1371-1, 1.1371-2, if an ETSC, and 1.1377-2(b) in their entity and continue to apply those rules in their entirety for the corporation's subsequent taxable years.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: September 9, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).