



# Internal Revenue Service

DEPARTMENT OF THE TREASURY

## LB&I Concept Unit

<b>Unit Name</b>	General Overview of Distributions and Accumulated Earnings & Profits	
<b>Primary UIL Code</b>	1368.00-00	Distributions

<b>Library Level</b>	<b>Title</b>
<b>Knowledge Base</b>	S Corporations
<b>Shelf</b>	S Corporations Issues
<b>Book</b>	Distributions
<b>Chapter</b>	S Corporations General Distributions Overview

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# General Overview

## General Overview of Distributions and Accumulated Earnings & Profits

The Practice Units on distributions highlight the audit steps that identify a variety of S corporation distribution issues and assist you in computing the taxability of such distributions to the shareholder(s).

This practice unit provides you with an overview of distributions. It also guides you to other practice units with more detailed information on potential examination issues, based on specific facts. The other three practice units addressing distributions from S corporations are:

- *Property Distribution Practice Unit*
- *Distributions With Accumulated Earnings & Profits Practice Unit*
- *Taxability of Distributions Not From Accumulated Earnings & Profits Practice Unit*



**CAUTION:** The statute of limitations must be protected at the shareholder level to assess tax arising from S corporation distributions. In certain distributions of appreciated property, the S corporation's statute of limitations must also be protected.

One of the main reasons to elect S corporation status is to avoid two levels of taxation. A C corporation is subject to tax at both the corporate level and again at the shareholder level when the corporation distributes its earnings to its shareholders. But an S corporation is, in most cases, taxed only at the shareholder level. Subchapter S has special rules for distributions that preserve this single-level taxation regime while accounting for any subchapter C history the corporation may have.

An S corporation can distribute to its shareholders either cash or property, each with its own tax treatment.

S corporation distributions are covered primarily by IRC 1368. Specifically, IRC 1368(b) provides rules for distributions from corporations that have no accumulated earnings and profits (AE&P), while IRC 1368(c) provides rules for distributions from S corporations that have AE&P. Thus, whether an S corporation has any C corporation AE&P affects the determination of the taxability of the distributions.

# General Overview (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

There are five items to consider when examining S corporation distributions:

- Determine the S corporation's corrected items of income, loss and deduction;
- Compute the amount of S corporation distributions;
- Determine the S corporation's source of distributions;
- Determine the S corporation's amount of AE&P, if any; and
- Determine the amount of the shareholder's stock basis.

# Facts of Concept

## General Overview of Distributions and Accumulated Earnings & Profits

### Facts of Concept

Review the S corporation's return for the following facts:

- Form 1120S, Page 1, Box A – S Election Effective Date
- Form 1120S, Page 1, Box E – Date Incorporated
- Form 1120S, Schedule B, line 8 – Net Unrealized Built-In Gain Amount
- Form 1120S, Schedule K, line 16d (and attached statement if required) – Distributions
- Form 1120S, Schedule K, line 17c – Dividend Distributions Paid from AE&P
- Form 1120S, Schedule L, line 7(b) and (d) – Loans to Shareholders
- Form 1120S, Schedule L, lines 22(b) and (d) – Capital Stock
- Form 1120S, Schedule L, lines 23(b) and (d) – Additional Paid-in Capital
- Form 1120S, Schedule L, line 24(b) and (d) – Retained Earnings
- Form 1120S, Schedule L, line 25(b) (and attached statement) – Adjustments to Shareholders' Equity
- Form 1120S, Schedule L, line 26(b) – Treasury Stock
- Form 1120S, Schedule M-2, line 1(a) – Analysis of Accumulated Adjustments Account
- Form 1120S, Schedule M-2, line 1(c) – Analysis of AE&P Form 1120S, Schedule M-2, line 1(d) – Analysis of, Other Adjustments Account
- Form 1120S, Schedule M-2, line 1(c) – Analysis of Shareholders' Undistributed Taxable Income Previously Taxed
- Form 1120S, Schedule D, Part III – Built-in Gains Tax
- Form 1125-E - Compensation of Officers
- Form 5452 - Corporate Report of Nondividend Distributions




**CAUTION:** Many S corporations selected for examination report items that may distort your analysis. Be sure to review the items comprehensively and critically, questioning each item for potential errors.

# Detailed Explanation of the Concept

## General Overview of Distributions and Accumulated Earnings & Profits

Before determining whether distributions are taxable, the correct amount of income, loss, and deduction for the current and all prior years must be determined.

Analysis	Resources
<p><u>Determine the Corporation's Corrected Items of Income, Loss and Deduction</u></p> <p>This is the first of the five items to consider when examining S corporation distributions. The taxability of distributions depends on the earnings of the corporation in the current and all prior years. If there are audit adjustments in the current or prior return years, the adjustments must be known before the taxability of distributions can be determined. These audit adjustments do not need to be finalized before you consider the taxability of distributions. However, until the final adjustments to items of income, loss, and deductions are known, the taxability of distributions can only be estimated.</p> <p> <b>CAUTION:</b> Taxpayers do not always properly consider the taxability of distributions; therefore, distributions can be taxable even when there are positive audit adjustments greater than the distribution amount. As a result, you should consider the effect of any audit adjustments on the taxability of distributions. For example, the sale or distribution of appreciated property to a related party (e.g., a shareholder) can result in increased taxable income and an increase in the distribution amount.</p>	<ul style="list-style-type: none"><li>▪ Audit Tool - S Corporation Operations Issue Guide</li><li>▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide</li><li>▪ Practice Unit - <i>Property Distribution</i></li><li>▪ Audit Tool - S Corporation Employment Tax &amp; Compensation Issues Guide</li></ul>

# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis

The amount of S corporation distributions should be adjusted based upon changes to the correct amount of income, loss, or deduction required to be reported at the S corporation level.

#### Compute the Correct Amount of S Corporation Distributions

This is the second of the five items. Many corporate-level issues can affect the amount of distributions from an S corporation including:

- Related party sales,
- Loans to shareholder,
- Inadequate or excessive compensation to shareholder-employees,
- Payment of shareholder's personal expenses,
- Corporate liquidation and redemption transactions, and
- Corporate bankruptcy and cancellation of debt.

The taxability of distributions issue should be developed concurrently with other corporate-level adjustments.

### Resources

- Audit Tool - S Corporation Transactions With Shareholders Issue Guide
- Practice Unit - *Property Distribution*
- Practice Unit – *Taxability of Distributions Not From Accumulated Earnings and Profits*
- Audit Tool - S Corporation Employment Tax & Compensation Issues Guide

# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p>Understanding the source of S corporation distributions can help to determine the taxability of distributions.</p> <p><u>Determine the S Corporation's Source of Distribution</u></p> <p>This is the third of the five items to determine the taxability of distributions: identify the source of the cash or assets distributed by the S corporation. There are five primary sources of cash from which an S corporation can source a distribution:</p> <ol style="list-style-type: none"><li>1. Earnings from S Corporation Years,</li><li>2. Capital Contributions or Loans from Shareholders,</li><li>3. Disposition of S Corporation Assets,</li><li>4. Third Parties (e.g. banks), and</li><li>5. Earnings from C Corporation Years.</li></ol> <p>A distribution in excess of a shareholder's stock basis generally occurs where there is a disproportionate distribution to the shareholder or from items 3, 4, or 5 above. In addition, there are three non-cash sources from which the corporation could generate funds to distribute: (1) accrued expenses, (2) improperly claimed expenses, and (3) diverted income.</p> <p>When an S corporation makes a significant distribution, determine the source of the distribution. By understanding the corporation's cash flow, you can better understand the operation of the corporation. An audit of an S corporation should be conducted in the same fashion as that of a C corporation. C corporation provisions apply to S corporations unless exceptions apply.</p>	<ul style="list-style-type: none"><li>▪ Audit Tool - S Corporation Audit Issue Guide</li></ul>



# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis

S corporation distributions may be taxed as dividends to the shareholder if the S corporation has AE&P.

#### Determine the S Corporation's Amount of AE&P, if Any

The fourth of the five items applies if the corporation was a C corporation and then made an election later to be treated as an S corporation. Compare Box A (S election effective date) and Box E (date incorporated) on the first page of the tax return.

Neither the Code nor the Treasury regulations define earnings and profits (E&P) but for purposes of this practice unit, E&P and AE&P are synonymous.

AE&P starts with taxable income. It is increased or decreased by the items described in IRC 312 and the regulations (money, principal amount of corporate debt, and the adjusted basis of other property distributed by the corporation). Generally, there is little difference between the AE&P of a C corporation and the accumulated retained earnings of that C corporation. As a result, a C corporation's retained earnings are sometimes used as an estimate of its AE&P. The next slides contain additional detail on this item.



### Resources

- Audit Tool - S Corporation Distributions Issue Guide
  
- IRC 312
  
- Subchapter S Revision Act of 1982

# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis

Before continuing the analysis, determine whether the tax return is reliable by reconciling the corporation's balance sheet and Schedule M-2. Complete both worksheets in the "Reconciliation" Excel workbook.

The workbook should be prepared for the year under examination. But since the taxability of distributions is cumulative over the life of the S corporation, the examiner may want to prepare the worksheet for multiple years. If there is a difference between the balance sheet and Schedule M-2, ask the taxpayer to explain. Generally, there are three possible explanations:

- The numbers on the balance sheet are incorrect and cannot be relied upon.
- An entry was made directly to "Retained Earnings" thereby skipping the income statement and tax return. Examine all such entries to determine if taxable income is under-reported.
- The distribution sections of the Schedule K and Schedule M-2 are incomplete or incorrect. The above analysis of the reconciliation workbook should detect if Schedule K and Schedule M-2 are incorrect. If no entries were made directly to the retained earnings other than actual distributions, then this analysis yields the distribution amount. Always reconcile any differences.

### Resources

- Form 1120S, Schedule L - *Balance Sheets per Books*
- Form 1120S, Schedule M-2 - *Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account*
- Audit Tool - Reconciliation Workbook
- IRM 4.10.3.9.4.23

# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis

### Resources

There are several ways to determine if an S corporation has AE&P. An S corporation reports dividend distributions on Form 1120S, Schedule K, line 17c and non-dividend distributions on Form 1120S, Schedule K, line 16d. If the S corporation reports a dividend distribution on line 17c or on Schedule M-2, column (c), then it's reporting it has AE&P. The following are from the 2018 Form 1120S, Schedule K and Schedule M-2.

- Form 1120S, Schedule K, line 16d – *Distributions*
- Form 1120S, Schedule K, line 17c – *Dividend Distributions Paid from Accumulated Earnings and Profits*

Items Affecting Shareholder Basis	Schedule K	
	Line	Description
16a	16a	Tax-exempt interest income . . . . .
	b	Other tax-exempt income . . . . .
	c	Nondeductible expenses . . . . .
	d	<b>Distributions (attach statement if required) (see instructions) . . . . .</b>
	e	Repayment of loans from shareholders . . . . .
Other Information	17a	Investment income . . . . .
	b	Investment expenses . . . . .
	c	<b>Dividend distributions paid from accumulated earnings and profits . . . . .</b>
	d	Other items and amounts (attach statement) . . . . .

**Schedule M-2** Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account (see instructions)

	(a) Accumulated adjustments account	(b) Shareholders' undistributed taxable income previously taxed	(c) Accumulated earnings and profits	(d) Other adjustments account
1	Balance at beginning of tax year . . . . .			
2	Ordinary income from page 1, line 21 . . . . .			
3	Other additions . . . . .			
4	Loss from page 1, line 21 . . . . .	( )		
5	Other reductions . . . . .	( )		( )
6	Combine lines 1 through 5 . . . . .			
7	Distributions . . . . .			
8	Balance at end of tax year. Subtract line 7 from line 6 . . . . .			

Per the Instructions for Form 1120S, the taxpayer may estimate the AE&P amount based on retained earnings of the last year of the C corporation. If an amount is on Schedule M-2, line 1(c), ask how the amount was determined and request documentation to support the computation.

- Form 1120S, Schedule M-2, line 1(c)
- Form 1120S Instructions

# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis



**DECISION POINT:** If there is a dividend distribution reported on Form 1120S, Schedule K, line 17c, or AE&P amount reported on Form 1120S, Schedule M-2, then the S corporation has AE&P. Use this Practice Unit to calculate the AE&P. Next, use the Distributions with AE&P Practice Unit to calculate how much of the distribution is a dividend.



**CAUTION:** If Form 1120S, Schedule M-2 is blank, don't automatically assume the S corporation does not have AE&P. S corporations sometimes fail to report AE&P on the return.

If the return does not report a dividend distribution or AE&P on Schedule M-2, then gather additional facts to determine if AE&P exists. Since an S corporation does not accumulate AE&P once it becomes an S corporation, determine how such AE&P was acquired.

An S corporation can accumulate or acquire AE&P in the following situations:

1. The S corporation has AE&P from years before the S election was made and it reported in those prior years as a C corporation.
2. The S corporation merges with a C corporation that has AE&P and the S corporation is the surviving corporation.
3. A wholly owned C corporation that has AE&P liquidates tax-free into the S corporation. The most common scenario is when an S corporation makes a QSub election for its wholly owned C corporation.

The following slides explain how to identify if one of these situations caused the S corporation to accumulate or acquire AE&P.

### Resources

- Form 1120S, Schedule K, line 17c – *Dividend Distributions Paid from Accumulated Earnings and Profits*
- Form 1120S, Schedule M-2 - *Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account*
- Practice Unit - *Distributions With Accumulated Earnings & Profits*
- IRC 1362
- IRC 368
- IRC 332

# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis

#### The S Corporation Has AE&P from Years When It Reported as a C Corporation

Look at page 1 of the Form 1120S. If the S corporation effective date (Box A) is later than the incorporation date (Box E), the S corporation may have AE&P from when it reported as a C corporation. However, the C corporation could have operated at a loss, resulting in no net AE&P.

#### The S Corporation Merges With a C corporation That Has AE&P and the S Corporation Is the Surviving Corporation

A tax-free merger of a C corporation into an S corporation results in the AE&P of the C corporation being carried over to the surviving S corporation. The balance sheet of the C corporation is added to the balance sheet of the S corporation. A significant positive balance in the following formula indicates a merger and may also indicate there is AE&P (all amounts from Form 1120S):

Form 1120S, Schedule L, Line 24(b) – Beginning Retained Earnings
Less
Form 1120S, Schedule M-2, Line 1(b) – Other Adjustments Account (OAA) balance at the beginning of the year.
Less
Form 1120S, Schedule M-2, Line 1(b) – Other Adjustments Account (OAA) balance at the beginning of the year.
Estimated AE&P

### Resources

- See Examples of the Concept, [Examples 1 and 2](#)
- IRC 1362
- IRC 1379(c)
- Form 1120S Instructions
  
- See Examples of the Concept, [Example 5](#)
- IRC 1371
- IRC 368
- IRC 381(c)(2)
- Form 1120S - *U.S. Income Tax Return for an S Corporation*

# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p><u>The S Corporation Merges With a C corporation That Has AE&amp;P and the S Corporation Is the Surviving Corporation (cont'd)</u></p> <p>In a tax-free merger, the S election date reported on Form 1120S, Page 1, Box A is the same as the date incorporated reported on Form 1120S, Page 1, Box E. Changes in commonly controlled entities on yK1 from year to year can also be used to identify merged entities. If there are indications that a merger took place, interview an officer or shareholder with knowledge of the company's history, capital structure, and operations to identify such merger transactions.</p>	<ul style="list-style-type: none"> <li>▪ yK1</li> <li>▪ IRM 4.10.3</li> </ul>
<p><u>A wholly Owned C Corporation That Has AE&amp;P Liquidates Tax-free into the S Corporation</u></p> <p>A common scenario of a tax-free liquidation is when an S corporation makes a qualified subchapter S (QSub) election for its wholly owned C corporation. If a valid QSub election is filed for the C corporation, then the C corporation is deemed to liquidate into the S corporation and treated as its division at the close of the day before the QSub election is effective. The liquidation of a corporation into the parent is generally a tax-free liquidation where the S corporation takes a carryover basis in the QSub's assets.</p> <p>A significant difference between the retained earnings and the Accumulated Adjustment Account (AAA) is an indication of AE&amp;P. Interview an officer or shareholder with knowledge of the company's history, capital structure, and operations to identify such liquidation transactions. Consider requesting IDRS information to identify QSub elections. yK1 can also be used to identify Qsubs. The S election and date incorporated may be the same.</p>	<ul style="list-style-type: none"> <li>▪ See Examples of the Concept, <a href="#">Example 6</a></li> <li>▪ IRC 1371</li> <li>▪ IRC 1361(b)(3)</li> <li>▪ IRC 332</li> <li>▪ IRC 334</li> <li>▪ Audit Tool - S Corporation Corporate Issues &amp; Advanced Topics Issue Guide</li> <li>▪ Audit Tool - S Corporation Non-TEFRA Procedures, Statutes &amp; Penalties Issue Guide</li> <li>▪ Form 1120S</li> <li>▪ IRM 4.10.3</li> <li>▪ IDRS</li> </ul>

# Detailed Explanation of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Analysis

### Resources



**DECISION POINT:** Determine the amount of AE&P if at least one of the three events exists:

- The S corporation has AE&P from previous C corporation years,
- The S corporation merged with a C corporation with AE&P, or
- A C corporation with AE&P liquidates tax-free into the S corporation.

If not, then you should analyze distributions without AE&P. See the *Taxability of Distributions Not From Accumulated Earnings & Profits* Practice Unit for more information.





**CAUTION:** If there are no identifiable corporate events in which AE&P may have been accumulated or acquired, but there is a significant unexplained difference in beginning retained earnings and beginning AAA, request that the taxpayer reconcile the two amounts, as there may be another issue.

- Practice Unit – *Taxability of Distributions Not From Accumulated Earnings & Profits*

- Audit Tool - Reconciliation Workbook

# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p><u>Determining the Amount of AE&amp;P</u></p> <p>There are simple ways to estimate an S corporation's amount of AE&amp;P:</p> <ol style="list-style-type: none"><li>1. Use the amount reported on Form 1120S, Schedule B, line 9.</li><li>2. Obtain a copy of the entity's last C corporation return, just before it made its S election, and use the amount reported as retained earnings.</li><li>3. Using Form 1120S, take the difference between Beginning Retained Earnings (Schedule L, line 24b) less Beginning AAA (Schedule M-2, line 1a) less Beginning OAA (Schedule M-2, line 1d)(RE&gt;AAA+OAA)</li></ol> <p>Once the estimated amount of AE&amp;P is determined, adjust as discussed below.</p> <p> <b>CAUTION:</b> The return available closest in time to the AE&amp;P acquisition event identified should be used for the most accurate estimate of AE&amp;P.</p> <p> <b>CONSULTATION:</b> If none of the above estimates are viable, then you should contact the Corporate Distributions &amp; Adjustments Practice Network for guidance on the actual computation of AE&amp;P.</p>	<ul style="list-style-type: none"><li>▪ Form 1120S</li><li>▪ Form 1120</li><li>▪ See Examples of the Concept, <a href="#">Example 1 to 4</a></li></ul>



# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p><u>Adjustments to AE&amp;P – General Rule</u></p> <p>When a C corporation elects S status, AE&amp;P is frozen at the start of the first S corporation year and can only be reduced by the following:</p> <ul style="list-style-type: none"><li>▪ Distributions treated as dividends;</li><li>▪ Payment of tax by the S corporation for the recapture of investment tax credits claimed during a C corporation year (rare); or</li><li>▪ Certain redemptions, liquidations, reorganizations, and divisions.</li></ul> <p>If a C corporation is audited after it converts to an S corporation, and additional taxable income is determined, the additional taxable income will increase the corporation's AE&amp;P while the payment of the tax will decrease the AE&amp;P. Any resulting tax paid during an S corporation year will not affect AAA.</p>	<ul style="list-style-type: none"><li>▪ IRC 1371</li><li>▪ IRC 1379(c)</li><li>▪ Form 1120S, Schedule K, line 17c</li></ul>

# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p><u>Adjustments to AE&amp;P – Unreported Dividends</u></p> <p>AE&amp;P is reduced by reported dividend distributions but is not reduced by unreported dividend distributions. The S corporation has the burden to establish that the dividend amount was reported by the shareholders before AE&amp;P is reduced. The duty of consistency precludes an S corporation from changing the character of distributions reported in closed statute years from non-dividend to dividend. Such a change would improperly reduce AE&amp;P by reported non-dividend distributions.</p> <p><u>Adjustments to AE&amp;P – Percentage of Completion Method of Accounting</u></p> <p>A C corporation's AE&amp;P is frozen as of the date of the S election, even if the C corporation's AE&amp;P was estimated under the percentage of completion method. Any adjustments made to this estimate after the S election is in place will apply to the AAA rather than the AE&amp;P. The courts strictly interpreted IRC 1371(c)(1); that is, no adjustment shall be made to the AE&amp;P of an S corporation, except for certain items noted in the Code.</p> <p><u>Adjustments to AE&amp;P – Not Affected by Reversal of Timing Differences Subsequent to S Election</u></p> <p>AE&amp;P is not adjusted for the reversal of timing differences that occur between C corporation years and S corporation years.</p>	<ul style="list-style-type: none"> <li>▪ IRC 1371(c)(1)</li> <li>▪ <i>Welch v. Helvering</i> - 290 U.S. 111 (1933)</li> <li>▪ 15 <i>Mertens Law of Fed. Income Tax'n</i> Section 60:5. Quasi-Estoppel or Duty of Consistency</li> <li>▪ IRC 1371(c)(1)</li> <li>▪ <i>Broadaway v. Comm'r</i> - 111 F.3d 593 (8<sup>th</sup> Cir. 1997), <i>aff'g Cameron v. Comm'r</i> - 105 T.C. 380 (1995)</li> <li>▪ See Examples of the Concept, <a href="#">Examples 4</a></li> </ul>

# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p><u>Adjustments to AE&amp;P - Corporate Transactions</u></p> <p>AE&amp;P is adjusted up or down based upon various corporate transactions such as certain redemptions, liquidations, reorganizations, divisions, etc. The rules of subchapter C are applied.</p> <p>When a redemption is treated as a sale or exchange, the corporation's AAA and AE&amp;P are reduced in proportion to the stock redeemed. However, when the redemption is treated as a distribution, the AAA and AE&amp;P are computed in the same way as any other distribution from an S corporation and it does not reduce AE&amp;P unless it is reported as a dividend distribution.</p> <p>In a complete liquidation of the S corporation, the distribution of the property is not subject to dividend treatment. In addition, all of the AE&amp;P is reduced to zero as a result of the liquidation. Note that a partial liquidation is treated in the same manner as a redemption.</p> <p>A spin-off, split-off, or split-up transaction requires the allocation of the AE&amp;P between the entities. See Treas. Reg. 1.312-10, Treas. Reg. 1.312-11, and the Corporate Distributions &amp; Adjustments Practice Network resources in the Corporate/Business Issues &amp; Credits Knowledge Base for additional information.</p>	<ul style="list-style-type: none"> <li>▪ IRC 1371(c)</li> <li>▪ Audit Tool - S Corporation Corporate Issues &amp; Advanced Topics Issue Guide</li> <li>▪ Practice Unit - <i>Distributions with No Accumulated Earnings &amp; Profits</i></li> <li>▪ Practice Unit - <i>Distributions With Accumulated Earnings &amp; Profits</i></li> <li>▪ IRC 312(n)(7)</li> <li>▪ IRC 301</li> <li>▪ IRC 302</li> <li>▪ IRC 331</li>   <li>▪ IRC 312(h)</li> <li>▪ Treas. Reg. 1.312-10</li> <li>▪ Treas. Reg. 1.312-11</li> <li>▪ Corporate/Business Issues &amp; Credits Knowledge Base</li> </ul>

# Detailed Explanation of the Concept (cont'd)

General Overview of Distributions and Accumulated Earnings & Profits	
Analysis	Resources
<p><u>Determining the Amount of the Shareholder's Stock Basis</u></p> <p>The fifth of the five items in determining the taxability of distributions is to understand shareholder stock basis. To the extent a distribution is not reported as a dividend, any distributions in excess of the shareholder's stock basis are taxed as capital gain.</p> <p>Treas. Reg. 1.6001-1(a) requires S corporation shareholders to maintain adequate books and records to substantiate their stock basis. Shareholders are also required to adjust their basis in accordance with IRC 1367. IRC 1368(b)(2) treats any distribution in excess of stock basis as a capital gain. Stock basis is used to determine the amount of tax-free distributions and to limit a shareholder's deductible losses.</p>	<ul style="list-style-type: none"> <li>▪ Practice Unit - <i>Taxability of Distributions Not From Accumulated Earnings &amp; Profits</i></li> <li>▪ Practice Unit - <i>Initial Stock Basis</i></li> <li>▪ Practice Unit - <i>Adjustments to Stock Basis</i></li> <li>▪ Practice Unit - <i>Stock Basis Ordering Rules</i></li> <li>▪ Practice Unit - <i>Valid Shareholder Debt Owed by S Corporation</i></li> <li>▪ Practice Unit - <i>Adjustments to Debt Basis</i></li> <li>▪ Practice Unit - <i>Losses Claimed in Excess of Basis</i></li> <li>▪ Audit Tool - <i>S Corporation Stock &amp; Debt Basis Issue Guide</i></li> <li>▪ Audit Tool - <i>S Corporation Shareholder Loss Limitations Issue Guide</i></li> <li>▪ Treas. Reg. 1.6001-1(a)</li> <li>▪ IRC 1367</li> <li>▪ IRC 1368</li> </ul>

# Examples of the Concept

## General Overview of Distributions and Accumulated Earnings & Profits

### Examples

#### Determine AE&P Using the Final C Corporation Return

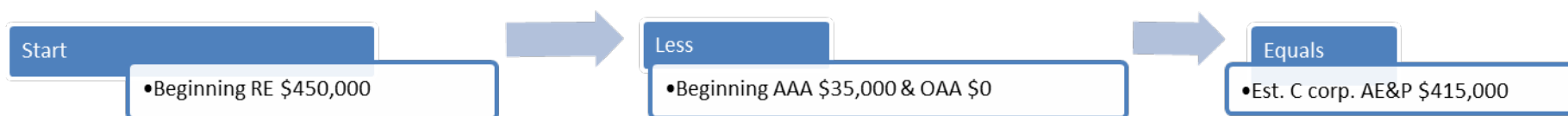
Example 1: The retained earnings on the final C corporation return, just before making the S election, is \$400,000. Thus, the estimated AE&P for the corporation is \$400,000. [Back to Slide](#)

Example 2: The tax return for the final year of the C corporation is not available, but the tax return for the initial year S corporation is available and it reported beginning retained earnings of \$400,000. This is the estimated AE&P for the corporation. [Back to Slide](#)

#### How to Determine AE&P Using the Current S Corporation Return

Example 3: An S corporation that previously reported as a C corporation is under examination. The balance sheet reflects beginning retained earnings of \$450,000, beginning AAA of \$35,000, and beginning OAA of \$0. Estimated C corporation AE&P is \$415,000.

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Example 4: Same facts as Example 3, except there are accumulated net timing differences of tax in excess of book deductions of \$5,000 in depreciation and \$7,000 in nondeductible travel and entertainment expenses. The estimated AE&P is reduced by the \$5,000 of depreciation timing differences but the permanent difference in nondeductible travel and entertainment expenses does not reduce the estimated amount of AE&P. Therefore, there is \$410,000 of estimated AE&P. The nondeductible travel and entertainment expenses already reduced retained earnings (as a deductible expense for book purposes) and AAA (as a nondeductible expense for tax purposes). Consequently, it is not an adjustment to arrive at AE&P. [Back to Slide](#)

# Examples of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Examples

#### Common Transactions Resulting in an S Corporation Acquiring AE&P Through a Merger or Liquidation

Example 5: Shareholder A wholly owns an S corporation and a C corporation. The S corporation and the C corporation are neither banks nor insolvent. There are no intercompany transactions.

The balance sheet of each entity reflects the following:

	S Corporation	C Corporation	Combined
Cash	500	14,500	15,000
Inventory	9,500	10,500	20,000
<b>Total Assets</b>	<b>10,000</b>	<b>25,000</b>	<b>35,000</b>
Accounts Payable	6,000	8,000	14,000
Capital Stock	100	200	300
Additional paid In Capital	900	1,800	2,700
Retained Earnings	3,000	15,000	18,000
<b>Total Liabilities and Shareholders' Equity</b>	<b>10,000</b>	<b>25,000</b>	<b>35,000</b>
AAA Balance	3,000	N/A	3,000
Estimated AE&P	0	15,000	15,000

Shareholder A contributes the C corporation's stock into the S corporation in an IRC 368(a)(1)(A) tax-free merger transaction. The S corporation is the surviving entity. The tax attributes of the C corporation, including any AE&P, carry over into the S corporation. Therefore, the estimated AE&P of the C corporation is \$15,000 based upon the ending retained earnings immediately before the merger transaction. The balance sheet of the S corporation immediately after the merger transaction is reflected in the combined column. Using the combined balance sheet immediately after the merger transaction, AE&P is estimated as retained earnings less the AAA balance. [Back to Slide](#)

# Examples of the Concept (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

### Examples

#### Common Transactions Resulting in an S Corporation Acquiring AE&P Through a Merger or Liquidation (cont'd)

Example 6: Shareholder A wholly owns an S corporation and a C corporation. The S corporation and the C corporation are neither banks nor insolvent. There are no intercompany transactions.

The shareholder contributes the C corporation stock into the S corporation in a tax-free reorganization under IRC 368(a). The S corporation then makes a QSub election under IRC 1361(b)(3)(B) for the C corporation, resulting in a deemed liquidation of the C corporation into the S corporation (Treas. Reg. 1.1361-4(a)(2)). Using the same balance sheet as Example 5, the same results occur as the AE&P of the C corporation is carried over to the S corporation upon the deemed liquidation of the C corporation when the QSub election is effective. The AE&P is still estimated as \$15,000 and AAA is still \$3,000.

The main difference between Example 5 and Example 6 is the C corporation no longer exists in Example 5 while the C corporation still exists in Example 6 but as a QSub of the S corporation. A QSub is disregarded for Federal income tax purposes but is not disregarded for other taxes like payroll and certain excise taxes, or for assessment of tax incurred in taxable years when it was a separate entity.

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# Index of Referenced Resources

## General Overview of Distributions and Accumulated Earnings & Profits

*Subchapter S Revision Act of 1982*

IRC 301

IRC 302

IRC 312

IRC 331

IRC 332

IRC 334

IRC 368

IRC 381

IRC 1361

IRC 1362

IRC 1367

IRC 1368

IRC 1371

IRC 1379

Treas. Reg. 1.312-10

Treas. Reg. 1.312-11



# Index of Referenced Resources (cont'd)

## General Overview of Distributions and Accumulated Earnings & Profits

Treas. Reg. 1.6001-1(a)

*Broadaway v. Comm'r* - 111 F.3d 593 (8<sup>th</sup> Cir.1997), *aff'g*, *Cameron v. Comm'r* - 105 T.C. 380 (1995)

*Welch v. Helvering* - 290 U.S. 111 (1933)

Form 1120 - *U.S. Corporation Income Tax Return*

Form 1120S - *U.S. Income Tax Return for an S Corporation*

Form 1120S Instructions

Form 1125 - *Compensation of Officers*

Form 5452 - *Corporate Report of Nondividend Distributions*

IRM 4.10.3

15 *Mertens Law of Federal Income Taxation* Sec 60:5. Quasi-Estoppel or Duty of Consistency

# Training and Additional Resources

General Overview of Distributions and Accumulated Earnings & Profits	
Type of Resource	Description(s)
White Papers / Guidance	<ul style="list-style-type: none"> <li>▪ Audit Tool - S Corporation Operations Issue Guide</li> <li>▪ Audit Tool - S Corporation Transactions With Shareholders Issue Guide</li> <li>▪ Audit Tool - S Corporation Employment Tax &amp; Compensation Issues Guide</li> <li>▪ Audit Tool - S Corporation Built-In Gains &amp; Other Taxes Issue Guide</li> <li>▪ Audit Tool - S Corporation Corporate Issues &amp; Advanced Topics Issue Guide</li> <li>▪ Audit Tool - S Corporation Audit Issue Guide</li> <li>▪ Audit Tool - S Corporation Non-TEFRA Procedures, Statutes &amp; Penalties Issue Guide</li> <li>▪ Audit Tool - S Corporation Distributions Issue Guide</li> <li>▪ Audit Tool - S Corporation Stock &amp; Debt Basis Issue Guide</li> <li>▪ Audit Tool - S Corporation Shareholder Loss Limitations Issue Guide</li> <li>▪ Audit Tool - FAQs - Distributions</li> </ul>
Articles	<ul style="list-style-type: none"> <li>▪ S Corp News IPG Issue #4 – January 2014, Loans to Shareholder or Disguised Distribution – Intercompany Account</li> </ul>
Databases / Research Tools	<ul style="list-style-type: none"> <li>▪ yK1</li> <li>▪ IDRS</li> <li>▪ Employee User Portal (EUP)</li> <li>▪ Corporate/Business Issues &amp; Credits Knowledge Base</li> </ul>
Other Training Materials	<ul style="list-style-type: none"> <li>▪ Audit Tool - Reconciliation Workbook</li> </ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
AAA	Accumulated Adjustment Account
AE&P	Accumulated Earnings and Profits
E&P	Earnings and Profits
EUP	Employee User Portal
IRM	Internal Revenue Manual
OAA	Other Adjustment Account
QSub	Qualified Subchapter S Subsidiary
yK1	yK1 Link Analysis Tool

# Index of Related Practice Units

<b>Associated UIL(s)</b>	<b>Related Practice Unit</b>
01367.00-00	<i>Initial Stock Basis</i>
01367.00-00	<i>Adjustments to Stock Basis</i>
01367.00-00	<i>Stock Basis Ordering Rules</i>
01367.00-00	<i>Valid Shareholder Debt Owed by S Corporation</i>
01367.00-00	<i>Adjustments to Debt Basis</i>
01367.00-00	<i>Losses Claimed in Excess of Basis</i>
01368.00-00	<i>Property Distribution</i>
01368.03-00	<i>Distributions With Accumulated Earnings &amp; Profits</i>
01368.02-00	<i>Taxability of Distributions Not From Accumulated Earnings &amp; Profits</i>