



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Transaction Unit

Unit Name	Taxability of Distributions Not From Accumulated Earnings & Profits	
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Issue and Transaction Overview

Taxability of Distributions Not From Accumulated Earnings & Profits

Before working through this practice unit, review the *General Overview of Distributions and Accumulated Earnings & Profits Practice Unit*. A few factual issues must be developed and considered before determining the taxability of distributions when there are no accumulated earnings and profits (AE&P).

The *General Overview of Distributions and Accumulated Earnings & Profits Practice Unit* addresses the following factual determinations:

1. The S corporation's corrected items of income, loss and deduction;
2. The correct amount of S corporation distributions;
3. The source of the S corporation's distributions;
4. Whether the S corporation has any AE&P from C corporation years, and the amount of any AE&P; and
5. The amount of shareholder's stock basis.

An S corporation has E&P only if (1) it used to be taxed as a C corporation and later converted to an S corporation, or (2) acquired a C corporation's assets in a transaction to which IRC 381 applies; that is, an IRC 368 reorganization or IRC 332 liquidation.

This Practice Unit addresses the taxability of distributions from an S corporation that either (1) does not have AE&P, or (2) makes distributions from sources other than AE&P; that is, nondividend distributions made from the accumulated adjustments account (AAA), other adjustments account (OAA), or a shareholder-level previously taxed income account (PTI) from before 1983 to the extent it still exists. This Practice Unit also addresses what items to consider to determine the taxability of nondividend distributions, liquidating distributions, and sale-or-exchange redemption distributions.

Issue and Transaction Overview (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

Taxability of Nondividend Distributions

Under IRC 1368, all distributions made by an S corporation without AE&P, and nondividend distributions, are nontaxable up to the shareholder's stock basis. Distributions exceeding the shareholder's stock basis are taxed as gain from the sale or exchange of property (generally capital gain). Note that a shareholder's basis in the stock is determined at the end of the taxable year of the S corporation, not at the time of the distribution from the S corporation.

To determine whether an S corporation's nondividend distribution is taxable, shareholders must first determine their stock basis. A common examination issue is shareholders' failure to maintain proper stock and debt basis computations over the life of their ownership in the S corporation, leading to improper reporting of losses and distributions in prior and current years. This may require a recomputation of basis from the time a shareholder first acquired shares in the S corporation. For additional information on stock basis, please see the S Corporation Stock & Debt Basis issue guide, and the three Practice Units on Initial Stock Basis, Adjustments to Stock Basis, and Stock Basis Ordering Rules.

 **CAUTION:** When a shareholder includes in income a capital gain from a distribution in excess of stock basis, the gain does not increase the shareholder's basis in stock. The only time a capital gain increases a shareholder's stock basis is when the gain is generated by the S corporation and passed through to the shareholder on Sch. K-1. A distribution in excess of stock basis is not reported to a shareholder on Sch. K-1 and therefore does not increase basis.

Issue and Transaction Overview (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

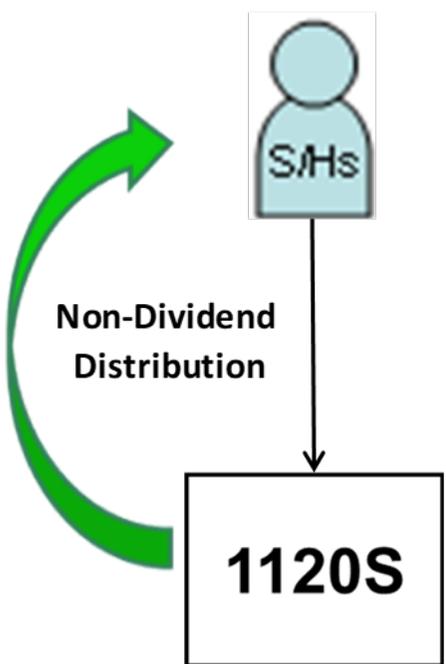
Other Nondividend Distribution Issues

Liquidations and redemptions are covered by special rules. If an S corporation has completely liquidated, then distributions are governed not by IRC 1368 but rather by IRC 336 and 331. With certain exceptions, IRC 336 requires that gain or loss be recognized to the liquidating corporation on the distribution of property as if such property were sold to the distributee (shareholder) at its fair market value (FMV). IRC 331 requires a separate gain or loss computation at the shareholder level upon distribution of the assets and liabilities from the S corporation.

If the S corporation is not liquidating but a shareholder disposes of shares by selling them back to the corporation in a redemption transaction under IRC 317(b), then under IRC 302 the purchase price paid by the corporation to the shareholder is treated not as a distribution but rather as the sale of stock by the shareholder to the corporation. If the transaction is a redemption treated as a stock sale, then the shareholder is allowed to offset the sales price with stock basis and report a capital gain or loss (with no potential for dividend treatment). If the transaction fails to meet the requirements for redemption as a stock sale then the transaction will result in a distribution under IRC 1368.

Transaction and Fact Pattern

Taxability of Distributions Not From Accumulated Earnings & Profits

Diagram of Transaction	Facts
 <p>The diagram illustrates a transaction where a shareholder (S/Hs) receives a non-dividend distribution from an S corporation (1120S). A downward arrow points from the shareholder icon to the 1120S box, and a large green curved arrow points from the 1120S box back to the shareholder icon, labeled 'Non-Dividend Distribution'.</p>	<p><u>Example 1</u></p> <ul style="list-style-type: none"> ▪ S corporation makes a nondividend distribution to the shareholder. ▪ The S corporation should report the nondividend distribution amount on: <ul style="list-style-type: none"> - Form 1120S, Schedule K, line 16d - distributions; - Form 1120S, Schedule K-1, box 16, Code D - distributions; - Form 1120S, Schedule M-2, line 7 - distributions other than dividend distributions (but may be limited); and - Form 1120S, Schedule L, line 24 - as a reduction of Retained Earnings. ▪ The shareholder should (1) account for the nondividend distribution amount in the basis computation, and (2) report the amount of the nondividend distribution that exceeds stock basis on Form 1040, Schedule D - <i>Capital Gains and Losses</i>. ▪ Examiner should review the distribution for proper reporting and tax impacts.

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Taxability of Distributions Not From Accumulated Earnings & Profits

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Taxability of Distributions Not From Accumulated Earnings & Profits

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Summary of Potential Issues

Taxability of Distributions Not From Accumulated Earnings & Profits	
<u>Issue 1</u>	Are nondividend distributions taxable?
<u>Issue 2</u>	How are complete liquidating distributions taxed?
<u>Issue 3</u>	How are redemption distributions taxed?

All Issues, Step 1: Initial Factual Development

Taxability of Distributions Not From Accumulated Earnings & Profits

A distribution is a payment of cash or property to the shareholder with respect to the shareholder's stock. It is important to identify (1) the proper distribution amount, and (2) whether the distribution is taxable to the shareholder.

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Identify the true shareholder to whom the distribution is allocated. 	<ul style="list-style-type: none"> ▪ Audit Tool - Identifying the True Shareholder Tool
<ul style="list-style-type: none"> ▪ Determine the proper amount of the current-year distributions, taking into account any audit adjustments, which may result in increases or decreases to the distribution amount: <ul style="list-style-type: none"> – Form 1120S, Schedule K, line 16d - distributions – Form 1120S, Schedule K-1, box 16, Code D - distributions – Form 1120S, Schedule K, line 17c - dividend distributions paid from AE&P – Form 1120S, Schedule M-2, line 7 - distributions 	<ul style="list-style-type: none"> ▪ Practice Unit - <i>General Overview of Distributions and Accumulated Earnings & Profits</i> ▪ Practice Unit - <i>Property Distribution</i> ▪ Audit Tool - S Corporation Distributions Issue Guide
<ul style="list-style-type: none"> ▪ Determine the amount of dividend vs. nondividend distributions. 	<ul style="list-style-type: none"> ▪ Practice Unit - <i>General Overview of Distributions and Accumulated Earnings & Profits</i> ▪ Practice Unit - <i>Distributions with Accumulated Earnings & Profits</i>

All Issues, Step 1: Initial Factual Development (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

Fact Element	Resources
<ul style="list-style-type: none">▪ Request a copy of the shareholder's stock and debt basis computation, if the computation is not already attached to the shareholder's income tax return.	<ul style="list-style-type: none">▪ Practice Unit - <i>Initial Stock Basis</i>

Issue 1, Step 3: Additional Factual Development

Taxability of Distributions Not From Accumulated Earning & Profits

[Issue 1](#)

Fact Element	Resources
<p>To determine the taxability of nondividend distributions, for each year review the shareholder's stock and debt basis computation for (1) accuracy of information and (2) proper tax reporting.</p> <ul style="list-style-type: none"> ▪ Review the shareholder's stock and debt basis computation: <ul style="list-style-type: none"> – Verify the shareholder's initial stock basis by obtaining documents to support purchases, gifts, or bequests of stock. – Obtain Sch. K-1 information from prior years via yK1, EUP, or by requesting copies from the shareholder and reconcile to the shareholder's basis schedule. – Ask about changes in ownership percentage and consider their impact on the basis computation. – Verify that stock basis (i.e. capital contributions from shareholder to the S corporation) and debt basis (i.e. loans from shareholder to the S corporation) are tracked separately. – Verify the stock and debt basis ordering rules were followed. <p> CAUTION: If the stock-basis computation is inaccurate, or a computation is not provided, then obtain the information noted above and reconstruct the basis computation using the Stock & Debt Basis Worksheet Tools.</p>	<ul style="list-style-type: none"> ▪ Practice Unit - <i>Initial Stock Basis Practice Unit</i> ▪ Practice Unit - <i>Stock Basis Ordering Rules</i> ▪ yK1 ▪ EUP ▪ Form 1120S, Schedule K-1 Instructions ▪ Audit Tool - Stock & Debt Basis Worksheet Tools

Issue 1, Step 3: Additional Factual Development (cont'd)

Taxability of Distributions Not From Accumulated Earning & Profits

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Review the shareholder's current and prior-income tax returns to:<ul style="list-style-type: none">– Verify whether dividend distributions were actually reported as dividend distributions,– Verify whether the Sch. K-1 items of income were actually reported as income,– Verify whether the loss and deduction items were actually suspended for the basis limitation,– Verify whether any prior-year distributions in excess of basis were reported as income, and– Verify any gain on loan repayments of reduced-basis debt reported as income. <p> CAUTION: If the shareholder's prior-year income tax returns do not match the reporting on the stock and debt basis computation, then obtain the information noted above and reconstruct the stock and debt basis computation using the Stock & Debt Basis Worksheet Tools.</p>	<ul style="list-style-type: none">▪ Practice Unit - <i>Adjustments to Stock Basis</i>▪ Practice Unit - <i>Stock Basis Ordering Rules</i>▪ yK1▪ EUP▪ Shareholder's Instructions for Schedule K-1 (Form 1120S) ▪ Audit Tool - Stock & Debt Basis Worksheet Tools

Issue 1, Step 4: Develop Arguments

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 1](#)

Explanation of Adjustment	Resources
<p>Correcting the shareholder's basis computation may be necessary to determine the correct amount of capital gain required to be reported for nondividend distributions.</p> <ul style="list-style-type: none">▪ Recompute the shareholder's stock and debt basis if there were any errors identified, including the following:<ul style="list-style-type: none">– If the Sch. K-1 items do not reconcile to the shareholder's stock and debt basis computation.– The shareholder failed to properly reduce basis for any sales or gifts of stock.– The shareholder failed to substantiate any purchases, gifts, or bequests that generated additional stock basis.– If the shareholder failed to track stock basis and debt basis separately.– If the stock and debt basis ordering rules were not followed.– If the shareholder did not properly report dividend distributions on the income tax return.– If the shareholder did not properly report any passthrough items of income on the income tax return.– If the shareholder did not properly limit Sch. K-1 loss or deduction items due to the basis limitation in any prior year on the income tax return.– If prior-year gains on loan repayment were not reported as income on the income tax return.	<ul style="list-style-type: none">▪ Practice Unit - <i>Adjustments to Stock Basis</i>▪ Practice Unit - <i>Stock Basis Ordering Rules</i>▪ Audit Tool - Stock & Debt Basis Worksheet Tools▪ IRC 1368(b)▪ IRC 1221

Issue 1, Step 4: Develop Arguments (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

Issue 1

Explanation of Adjustment	Resources
<p>Upon review of the computation or recomputation of shareholder basis, if there are errors then determine if the exam year's distribution(s) exceeded stock basis based upon the exam-year ordering rules. Consider only stock basis and not debt basis in computing the gain on nondividend distributions.</p> <p>The current-year stock basis is adjusted in the following order (assuming there is no alternative ordering election in place):</p> <ol style="list-style-type: none"> 1. Increased for income items and excess depletion. 2. Decreased for prior-year losses in excess of basis from closed statute years. 3. Decreased for nondividend distributions (i.e., any distributions that are not from AE&P). 4. Decreased for nondeductible, noncapital expenses and depletion. 5. Decreased for items of loss and deduction. <p>If a nondividend distribution exceeds stock basis under these ordering rules, the distribution is taxable to the shareholder as a capital gain on Schedule D. Any capital gain from a distribution in excess of stock basis is long term if the shareholder held the stock for more than 12 months, and short term if held for 12 months or less.</p>	<ul style="list-style-type: none"> ▪ Practice Unit - <i>Adjustments to Stock Basis</i> ▪ Practice Unit - <i>Stock Basis Ordering Rules</i> ▪ Audit Tool - Stock & Debt Basis Worksheet Tools ▪ Practice Unit - <i>S Corporation Losses Claimed in Excess of Basis</i> ▪ IRC 1368(b) ▪ Treas. Reg. 1.1367-1(f) ▪ TAM 200619021 ▪ IRC 1221

Issue 2, Step 2: Review Potential Issues

Taxability of Distributions Not From Accumulated Earnings & Profits

Issue 2

How are complete liquidating distributions taxed?

Explanation of Issue	Resources
<p>IRC 1371(a) provides that except as otherwise provided, and except to the extent inconsistent with subchapter S, S corporations are subject to all the rules of C corporations.</p> <p>IRC 301(c) covers distributions of property made by a corporation to a shareholder with respect to its stock. But subchapter S contains its own set of rules on regular (i.e. nonliquidating) distributions of an S corporation. IRC 1368(b) addresses distributions by an S corporation having no earnings and profits, IRC 1368(c) addresses distributions by an S corporation having earnings and profits.</p> <p>There is, however, no subchapter S provision addressing the treatment of distributions arising from complete liquidations of the S corporation. Therefore, since subchapter C applies as noted above, we turn to IRC 331 for the treatment of amounts received by a shareholder in complete liquidation of a corporation, and IRC 336 for the treatment of the distribution to the corporation.</p>	<ul style="list-style-type: none">▪ IRC 1371▪ IRC 1368▪ IRC 301 ▪ IRC 331 ▪ IRC 336

Issue 2, Step 2: Review Potential Issues (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Issue	Resources
<p>According to IRC 1371(a), Subchapter C provides rules for corporations and for shareholders when an S corporation completely liquidates, unless the Subchapter C rules are inconsistent with Subchapter S.</p> <ul style="list-style-type: none">▪ IRC 336 addresses liquidating distributions at the corporate level.▪ IRC 331 addresses liquidating distributions at the shareholder level. <p>There are two types of liquidations: (1) the corporation sells its assets to a third party and then distributes the cash it receives for the assets to its shareholders; and (2) the corporation distributes its assets directly to the shareholders.</p> <p>Upon an S corporation's liquidation, IRC 336(a) requires the recognition of gain or loss to the corporation as if all the distributed assets were sold at their fair market value. If the S corporation sells all its assets to a third party as part of a plan of liquidation, then the gain or loss is recognized by the corporation irrespective of any plan of liquidation and just cash remains for the IRC 336(a) gain computation. However if the assets are distributed to the shareholders as part of the liquidation then the gain or loss must be recognized based upon the FMV of the assets distributed.</p>	<ul style="list-style-type: none">▪ IRC 1371▪ IRC 336▪ IRC 331▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide <ul style="list-style-type: none">▪ IRC 1001▪ Audit Tool - S Corporation Built-in Gains & Other Taxes Issue Guide

Issue 2, Step 2: Review Potential Issues (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Issue	Resources
<ul style="list-style-type: none"> ▪ There is a special rule in IRC 336 when a shareholder assumes a liability of the corporation in a liquidating distribution. In determining the gain or loss on the assets distributed, if an asset subject to a liability is distributed to a shareholder (or a shareholder assumes a liability of the corporation in connection with the distribution of that asset), then under IRC 336(b) the FMV of that asset is deemed not to be less than the amount of the liability. This results in a larger IRC 336 gain (or a smaller loss). ▪ Note that built-in gains and other corporate-level taxes can apply due to the taxable disposition of assets during liquidation <p>Once the gain at the S corporation level is computed and allocated to the shareholders under IRC 336 and 1366, the assets are then distributed to the shareholders. The distribution amount is equal to the FMV of the asset reported under IRC 336 less any liabilities assumed by the shareholder. The distribution amount is compared to the shareholder's ending stock basis to compute a capital gain or loss at the shareholder level under IRC 331. In other words, the distribution is treated as a return of capital to the extent of the shareholder's basis. There is no adjustment to the shareholder's stock basis associated with the shareholder's assumption of a liability on liquidation.</p> <p>Since the shareholder's stock basis is adjusted for all corporate gains and losses, there is generally very little IRC 331 gain or loss on the liquidation, assuming the corporation was never a C corporation nor engaged in a tax-free reorganization or tax-free liquidation with a C corporation. On the other hand, there could be an IRC 331 gain or loss on liquidation if the shareholder acquired stock from another shareholder, or if the shareholder assumed liabilities in liquidation that exceeded the FMV of the assets.</p>	<ul style="list-style-type: none"> ▪ IRC 336 ▪ IRC 1366 ▪ IRC 331 ▪ CCA 201237017 ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide

Issue 2, Step 3: Additional Factual Development

Taxability of Distributions Not From Accumulated Earnings & Profits

Issue 2

Fact Element	Resources
<ul style="list-style-type: none">▪ Request a copy of any presentation provided to the S corporation or shareholders to explain the transaction steps.<ul style="list-style-type: none">– If none is provided, consider requesting a presentation regarding the steps of the transaction and the various tax consequences reported.– If needed, perform interviews to understand the purpose of the transaction.▪ Request copies of the plan of liquidation, board minutes, resolutions, or other documents evidencing a complete liquidation of the corporation.▪ Request copies of any tax opinion on the tax consequences of the transaction.▪ Request copies of any valuations of the S corporation's stock or assets distributed.▪ Request information about any potential corporate-level taxes.▪ Request a copy of the corporation's workpapers that address gain or loss upon liquidation. The workpapers should address how any gain or loss was allocated among the various assets.▪ Request a copy of the corporation's balance sheet immediately before the transaction.	<ul style="list-style-type: none">▪ Audit Tool - S Corporation Built-in Gains & Other Taxes Issue Guide

Issue 2, Step 4: Develop Arguments

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources
<p><u>Character of Gain or Loss</u></p> <ul style="list-style-type: none"> ▪ A significant part of an audit adjustment may be the character of the IRC 336 and IRC 331 gain or loss. If the IRC 336 gain is ordinary yet the IRC 331 loss is capital, though the numbers may offset each other, the tax consequence could be greatly different since capital losses are generally limited to capital gains. ▪ The IRC 336 gain or loss can be a combination of ordinary, IRC 1231 and capital gain or loss. Look to the corporate assets that are deemed to be sold and compute their individual gain or loss. The character of the gain or loss depends on the type of asset and whether there is depreciation recapture, etc. If the assets are goodwill, the character of the gain is generally capital. ▪ IRC 1239 may require capital gains to be reported as ordinary income when depreciable property is sold to a related party. ▪ The shareholder's IRC 331 gain or loss is capital since it is computed as if the shareholder sold their stock for the amount of the liquidating distribution. The sale of stock is a capital transaction that generates a capital gain or loss. <ul style="list-style-type: none"> – Verify the shareholder's basis computation, as discussed in Issue 1, to ensure the correct gain or loss is reported. 	<ul style="list-style-type: none"> ▪ IRC 331 ▪ IRC 336 ▪ IRC 1231 ▪ IRC 1239 ▪ Practice Unit - <i>Property Distribution</i> ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide

Issue 2, Step 4: Develop Arguments (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources
<p><u>Undervaluing the FMV of Assets Distributed</u></p> <ul style="list-style-type: none">▪ One of the most important items needed to compute the corporate gain or loss on liquidation is the balance sheet at the moment before the liquidating distribution. Verify that all assets, whether booked or unbooked, are reported as part of the transaction. In particular, unbooked goodwill is most commonly not accounted for as part of the liquidation.▪ In addition, when a corporation liquidates, there is no willing buyer and seller under the standard definition of FMV (the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts), so it can be difficult to determine the value of the assets.<ul style="list-style-type: none">– A liquidation requires a valuation of the assets and not the stock. Sometimes it is impractical, however, to value each asset due to the volume of assets. In such cases, the stock is valued. A stock valuation requires several adjustments to arrive at an asset valuation. For more information see the Built-in Gains & Other Taxes Issue Guide for information on valuing assets versus stock.	<ul style="list-style-type: none">▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide ▪ Audit Tool - S Corporation Built-in Gains & Other Taxes Issue Guide

 **CONSULTATION:** Consider consulting a valuation specialist.

Issue 2, Step 4: Develop Arguments (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources
<p><u>Corporate Level Taxes</u></p> <ul style="list-style-type: none"> ▪ The S corporation can be subject to various corporate-level taxes upon the sale or disposition of assets. The built-in gains tax can trigger corporate-level taxes such as the tax on excessive net passive investment income, LIFO recapture tax, credit for fuel taxes paid, and recapture of prior-year credits. <p><u>Loss Disallowance Rules</u></p> <ul style="list-style-type: none"> ▪ While losses are generally allowed upon a complete liquidation, there are certain losses that are disallowed when property is distributed to a related person under IRC 267, which includes a majority shareholder who owns more than 50% of the stock after considering the constructive ownership rules. The loss can be disallowed if: <ul style="list-style-type: none"> – The distribution is not pro rata, or – The property distributed is disqualified property. <ul style="list-style-type: none"> ▪ Disqualified property is any property received by the corporation (1) in an IRC 351 transaction or (2) as a contribution to capital during the 5-year period ending on the date of the distribution. ▪ In addition, under IRC 336(d), a loss can be disallowed in complete liquidation, whether sold or distributed, if the property was acquired in an IRC 351 transaction, or as a capital contribution, and a principal purpose of the acquisition of the property was to recognize a loss upon liquidation. 	<ul style="list-style-type: none"> ▪ IRC 1374 ▪ IRC 1375 ▪ IRC 336 ▪ IRC 267 ▪ IRC 351

Issue 3, Step 2: Review Potential Issues

Taxability of Distributions Not From Accumulated Earnings & Profits

Issue 3

How are stock redemptions taxed?

Explanation of Issue	Resources
<p>If the S corporation is not completely liquidated, then its shareholders can (1) sell their stock to another person or entity, or (2) sell the stock back to the corporation. The second method, selling stock back to the corporation, is referred to as a stock redemption.</p> <p>IRC 302 under subchapter C governs the tax consequences of stock redemptions; there are no special subchapter S provisions. Under IRC 302, a stock redemption can be either:</p> <ul style="list-style-type: none">▪ A sale or exchange of the stock covered under IRC 1001 and 1221, or▪ A distribution governed by IRC 1368.	<ul style="list-style-type: none">▪ <i>BNA Tax Management Portfolios U.S. Income Series C Corporations 767-3rd: Redemptions</i>▪ IRC 302▪ IRC 1001▪ IRC 1221▪ IRC 1368

Issue 3, Step 2: Review Potential Issues (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

Issue 3

Explanation of Issue	Resources
<p>Four separate fact patterns meet the sale or exchange requirements for S corporations. Otherwise, the transaction will automatically be a distribution under IRC 1368.</p> <p>The first three fact patterns are less common:</p> <ul style="list-style-type: none"> ▪ Redemptions not essentially equivalent to dividends (IRC 302(b)(1)); ▪ Termination of shareholder's entire interest (IRC 302(b)(3)); and ▪ A redemption in partial liquidation of the business (for example, the distribution of proceeds from an insurance payout for the destruction of a manufacturing facility that will not be rebuilt, resulting in a contraction of the business) (IRC 302(b)(4) and (e)). <p>The fourth fact pattern, substantially disproportionate redemptions under IRC 302(b)(2), has three requirements:</p> <ul style="list-style-type: none"> ▪ After the redemption, the redeemed shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote; ▪ The percentage of the corporation's voting stock owned by the redeemed shareholder immediately after the redemption is less than 80 percent of the corporation's voting stock owned by the redeemed shareholder immediately before the redemption; and ▪ The redeemed shareholder's percentage of the common stock of the corporation meets a similar 80 percent test. <p>The attribution rules of IRC 318 apply unless certain requirements are met.</p>	<ul style="list-style-type: none"> ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide ▪ IRC 1368 ▪ IRC 302 ▪ <i>U.S. v. Davis</i> - 397 U.S. 301 (1970) ▪ IRC 318

Issue 3, Step 3: Additional Factual Development

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 3](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Request a copy of any presentation provided to the S corporation or shareholder to explain the transaction steps.<ul style="list-style-type: none">– If none provided, consider requesting a presentation regarding the steps of the transaction and the various tax consequences reported.– If needed, perform interviews to understand the purpose of the transaction.▪ Request copies of any tax opinion on the tax consequences of the transaction.▪ Request copies of any valuation of the S corporation's stock or assets used as part of the transaction.▪ Request a determination of the corporation's AE&P, if any.▪ Request a schedule of the number of shares owned by all shareholders (whether or not under examination) immediately before and after the redemption.▪ Request any information that would help establish any relationship among the shareholders (both before and after the redemption).▪ Request information, for example, board minutes, disclosures in financial statements, evidencing the sale or involuntary conversion of a division or business operation by the corporation before the redemption.	<ul style="list-style-type: none">▪ Audit Tool - S Corporation Built-in Gains & Other Taxes Issue Guide▪ Practice Unit - <i>Property Distribution</i>

Issue 3, Step 4: Develop Arguments

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 3](#)

Explanation of Adjustment	Resources
<p> CONSULTATION: Consider contacting the Corporate Distributions & Adjustments Practice Network to determine whether the distribution qualifies as a stock redemption.</p> <p><u>Improper Reporting as Stock Sale</u></p> <ul style="list-style-type: none">▪ If the distribution qualifies as a redemption receiving sale or exchange treatment, then the shareholder will report the disposition as a capital gain or loss just as if the shareholder had sold the stock to an unrelated individual. If the distribution is not treated as a redemption then it is treated like any other distribution potentially resulting in dividend treatment.<ul style="list-style-type: none">– A sale or exchange redemption resulting in capital gain or loss reduces the AAA and AE&P in proportion to the shares redeemed even though the shareholder does not report the distribution as a dividend. Therefore a redemption is often preferred by shareholders. But the shareholder must meet the requirements for sale or exchange treatment as a redemption in order to receive the benefits.– Sale or exchange treatment (capital gain or loss) is most commonly preferred when there is little AAA and substantial AE&P.	<ul style="list-style-type: none">▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide

Issue 3, Step 4: Develop Arguments (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

[Issue 3](#)

Explanation of Adjustment	Resources
<p><u>Use of Stock Basis to Offset Income</u></p> <ul style="list-style-type: none">As with any stock sale, if only part of the shareholder's stock is redeemed, only a portion of the shareholder's stock basis can be used to offset the sales price in arriving at the gain or loss on sale. <p><u>The Shareholder Receives More than the FMV of the Stock</u></p> <ul style="list-style-type: none">If the fair market value of the redeemed stock is less than the amount paid by the S corporation for the shareholder's stock, then the IRS may treat the difference as a dividend under IRC 301, compensation from the corporation, or a gift to the redeeming shareholder from the other shareholders. <p><u>Improper Reporting as a Distribution</u></p> <ul style="list-style-type: none">While less common, a distribution that qualifies as a redemption, receiving sale or exchange treatment, may be reported as a distribution. A distribution may be preferable if there is little or no AE&P and the shareholder is redeeming only part of their stock. A distribution is preferable because in a partial redemption, to which sale or exchange treatment applies, only a portion of the stock basis may be used to offset the redemption amount. A distribution is preferable because the shareholder's entire stock basis is available to offset the distribution amount.	<ul style="list-style-type: none">Audit Tool - S Corporation Distributions Issue GuideTreas. Reg. 1.301-1(j)Rev. Rul. 59-97Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide

Index of Referenced Resources

Taxability of Distributions Not From Accumulated Earnings & Profits

IRC 267

IRC 301

IRC 302

IRC 318

IRC 331

IRC 336

IRC 351

IRC 1001

IRC 1221

IRC 1231

IRC 1239

IRC 1366

IRC 1368

IRC 1371

IRC 1374

IRC 1375

Treas. Reg. 1.1367-1(f)

Index of Referenced Resources (cont'd)

Taxability of Distributions Not From Accumulated Earnings & Profits

U.S. v. Davis - 97 U.S. 301 (1970)

CCA 201237017

Form 1120S

Form 1120S, Schedule K-1

Form 1120S, Schedule K-1 Instructions

Form 1040, Schedule D

Training and Additional Resources

Taxability of Distributions Not From Accumulated Earnings & Profits	
Type of Resource	Description(s)
Articulate Course	<ul style="list-style-type: none"> ▪ <i>S Corporation Distributions</i> – ITM Course # 72814
Issue Toolkits	<ul style="list-style-type: none"> ▪ Audit Tool - S Corporation Stock and Debt Basis Issue Guide ▪ Audit Tool - S Corporation Distributions Issue Guide ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide ▪ Audit Tool - S Corporation Built-in Gains & Other Taxes Issue Guide ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide ▪ Audit Tool - Stock & Debt Basis Worksheet Tools
Databases / Research Tools	<ul style="list-style-type: none"> ▪ yK1 ▪ Employee User Portal (EUP)
Reference Materials	<ul style="list-style-type: none"> ▪ <i>Practitioners Publishing Company (PPC) - 1120S Deskbook</i> Ch. 21: Distributions Key Issue 21C: Making Distributions from S corporations with No AE&P ▪ <i>BNA Tax Management Portfolios U.S. Income Series Other Pass-Through Entities 731</i> S Corporations: Operations IV. Treatment of S Corporation Distributions ▪ <i>BNA Tax Management Portfolios U.S. Income Series C Corporations 767-3rd</i>: Redemptions

Glossary of Terms and Acronyms

Term/Acronym	Definition
AAA	Accumulated Adjustments Account
AE&P	Accumulated Earnings & Profits
CCA	Chief Counsel Advice
EUP	Employee User Portal
FMV	Fair Market Value
OAA	Other Adjustments Account
PTI	Previously Taxed Income
Treas. Reg.	Treasury Regulation
yK1	The yK1 Program

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
1367	<i>Adjustments to Stock Basis</i>
1368	<i>Distributions with Accumulated Earnings & Profits</i>
1368	<i>General Overview of Distributions and Accumulated Earnings & Profits</i>
1368	<i>Property Distribution</i>
1367	<i>Stock Basis Ordering Rules</i>
1367	<i>Valid Shareholder Debt Owed by S Corporation</i>