



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I Transaction Unit

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Issue and Transaction Overview


Distributions with Accumulated Earnings & Profits

General Overview

This Practice Unit provides information on typical issues that might be encountered in the course of examining S corporation distributions when the S corporation has accumulated earnings and profits.

This document is organized into several steps to help you conduct an audit. It also provides information on the common issues and fact patterns for this transaction.

This Practice Unit is only applicable if there is Accumulated Earnings & Profits (AE&P), so before proceeding, review the General Overview of Distributions and Accumulated Earnings & Profits Practice Unit and determine AE&P.

-  **CAUTION:** As discussed in the *General Overview of Distributions and Accumulated Earnings & Profits* Practice Unit, the taxability of distributions requires the determination of several key items prior to addressing the taxability of distributions from AE&P including:
- Determine the corporation's corrected items of income, loss and deduction,
 - Compute the correct amount of S corporation distributions,
 - Determine the S corporation's source of distributions, and
 - Determine the S corporation's AE&P, if any.

Issue and Transaction Overview

Distributions with Accumulated Earnings & Profits

A C corporation has two levels of taxation, one at the corporate level and one at the shareholder level when the corporation distributes its earnings and profits to the shareholder(s) (i.e. a dividend). The S corporation income, loss and deduction items pass through to the shareholder(s) and are taxed or deducted at the shareholder level. One advantage of an S corporation is a single level of taxation, however there are situations where an S corporation distribution is taxable to the S corporation shareholder creating a second level of tax similar to a dividend distribution for a C corporation shareholder. Distributions from an S corporation can be either in cash or property; the tax effect of which to the shareholder can be non-taxable, long-term or short-term capital gain income, or ordinary or qualified dividend income.

Sourcing the Distribution - General

The taxability of S corporation distributions is covered primarily by IRC 1368. The distribution must be sourced by the S corporation to determine its taxability as a dividend or non-dividend distribution.

IRC 1368(c), 1379(c) and the Instructions for Form 1120S state that a distribution made by an S corporation with AE&P is made (or sourced) from the following items (in the order listed):

1. Accumulated Adjustments Account (AAA),
2. Previously Taxed Income (PTI) under IRC 1379(c),
3. Accumulated Earnings & Profits (AE&P) (i.e. a dividend distribution),
4. Tax Exempt Income in the Other Adjustments Account (OAA),
5. Non-taxable up to the shareholder's stock basis (i.e. a return of capital),
6. Any distributions in excess of the shareholder's stock basis will be taxed as a capital gain (i.e. a deemed sale of stock with no basis).

IRC 1368(c)(3) provides that any portion of a distribution remaining after the application of item 3 is treated consistently with IRC 1368(b), which states that all distributions made by an S corporation that do not have any AE&P will be:

1. Non-taxable up to the shareholder's stock basis (i.e. a return of capital), and
2. Any distributions in excess of the shareholder's stock basis will be taxed as a capital gain (i.e. a deemed sale of stock with no basis).

Issue and Transaction Overview

Distributions with Accumulated Earnings & Profits

Sourcing the Distribution - Elections to Change the Sourcing from AAA, PTI, AE&P, OAA

An S corporation can make one or more of four possible elections, with the consent of all affected shareholders, to change the distribution source as described in Treas. Reg. 1.1368-1. The S corporation can elect to:

- Distribute AE&P before AAA,
- Forego sourcing distributions from PTI,
- Create a deemed dividend distribution to the extent of AE&P followed by a deemed capital contribution for the same amount,
- Report separate tax years for purpose of the first three elections if there is a qualifying disposition.

Sourcing From AAA

Thus, for S corporations with AE&P, verify its AAA, as any distribution in excess of AAA may be taxed as a dividend. AAA first came into existence for taxable years beginning after 1982. It represents the cumulative total of pass-through items generated by the S corporation, which have been taxed to the shareholders, and that remain undistributed by the S corporation. The AAA is a corporate account and does not belong to any particular shareholder. Thus, when an S corporation shareholder sells their stock, the AAA is unaffected. Unlike stock basis, the AAA can have a negative balance. The negative balance can be created by the pass through of loss and deduction items. Treas. Reg. 1.1368-2(a)(3)(ii). Distributions sourced from AAA are reported as non-dividend distributions by the S corporation to the shareholder. Keep in mind that non-dividend distributions can still be taxable to the shareholder as a capital gain to the extent the non-dividend distribution exceeds shareholder stock basis.

Issue and Transaction Overview

Distributions with Accumulated Earnings & Profits

Sourcing from PTI

If the distribution is not sourced from AAA it can still be treated as a non-dividend distribution if the distribution is sourced from the PTI account. S corporation income, losses and deductions from before 1983 are recorded in PTI accounts. Any amount in these accounts apply to specific shareholders and can't be transferred to another shareholder. It is rare for an S corporation to have PTI since the election must have been made before 1983 and the current shareholder must have continuously owned S corporation stock from prior to 1983.

Sourcing from AE&P

If the distribution is not sourced from AAA or PTI, then the distribution is a dividend to the extent of AE&P. AE&P is generally the cumulative C corporation taxable income that is increased or decreased by the items described in IRC 312 and the Regulations. Generally, there is little difference between the AE&P of a C corporation and the accumulated retained earnings of that C corporation.

Sourcing from OAA

As discussed later in this Practice Unit, the AAA computation does not include tax-exempt income and the expenses related to the tax-exempt income. Tax-exempt items of income and expense are recorded in the OAA. All distributions after the AE&P is exhausted are non-dividend distributions. Therefore, the only purpose of the OAA account is to help the S corporation determine the source of the distribution that is not from S corporation taxable earnings (AAA or PTI), or C corporation taxable earnings (AE&P).


Issue and Transaction Overview

Distributions with Accumulated Earnings & Profits

S Corporation Reporting

Once the S corporation has properly sourced the dividend distributions from AE&P and exhausted its AE&P, all other distributions are non-dividend distributions regardless of their source. Dividend and non-dividend distributions are reported separately. The S corporation reports all dividends on Form 1120S, Schedule K, line 17c and issues a Form 1099-DIV to the shareholders to report their individual dividends. Non-dividend distributions are reported on Form 1120S, Schedule K, line 16d, and on Schedule K-1, line 16d to the shareholders.

If the non-dividend distribution exceeds the shareholder's stock basis, the non-dividend distribution may still be taxable to the shareholders as a long-term or short-term capital gain. Please see the Taxability of Distributions Not From Accumulated Earnings and Profits Practice Unit for additional information on the taxability of non-dividend distributions.

 **CAUTION:** If the distribution is part of a stock redemption transaction or a complete liquidation of the S corporation, the distribution might not be reportable as a dividend distribution even though it otherwise would be a dividend distribution according to the sourcing rules above. Please see the Taxability of Distributions Not From Accumulated Earnings and Profits Practice Unit for additional information on stock redemption transactions and complete liquidations of the S corporation.

Issue and Transaction Overview

Distributions with Accumulated Earnings & Profits

AAA Ordering Rules – Regular Ordering

Since both losses and distributions are used in the computation of the AAA, it is important to understand the ordering rules of items that adjust the AAA. The ordering rules for the AAA are not the same as the ordering rules for stock basis. Distributions are applied to stock basis after current period income items but before non-deductibles and current period losses and deductions. This will result in more tax-free distributions, along with more deferred S corporation losses due to a lack of stock basis.

Per Treas. Reg. 1.1368-2(a)(5), the AAA ordering rules are:

1. Increased for income items and excess depletion;
2. Decreased for non-deductible, non-capital expenses and depletion;
3. Decreased for items of loss and deduction; and
4. Decreased for non-dividend distributions without making AAA negative.

Any distribution in excess of AAA is sourced from the next category of PTI, AE&P, then OAA as described in IRC 1368(c). The Sch. M-2 row items follow the AAA ordering rules.

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				

Issue and Transaction Overview

Distributions with Accumulated Earnings & Profits

AAA Ordering Rules – Net Negative Adjustment Ordering

The AAA ordering rules are modified if the S corporation has a "net negative adjustment." IRC 1368(e)(1)(C). A "net negative adjustment" occurs when the S corporation's current year income items less the loss, deduction and non-deductible expenses (includable in the AAA computation) results in a negative number. The "net negative adjustment" rule allows distributions to be taken from beginning AAA, if the S corporation has a net loss for the year. Under the Small Business Job Protection Act of 1996, for tax years starting after December 31, 1996 when the S corporation has a net negative adjustment then per IRC 1368(e)(1)(C), the net negative adjustment AAA ordering rules are:

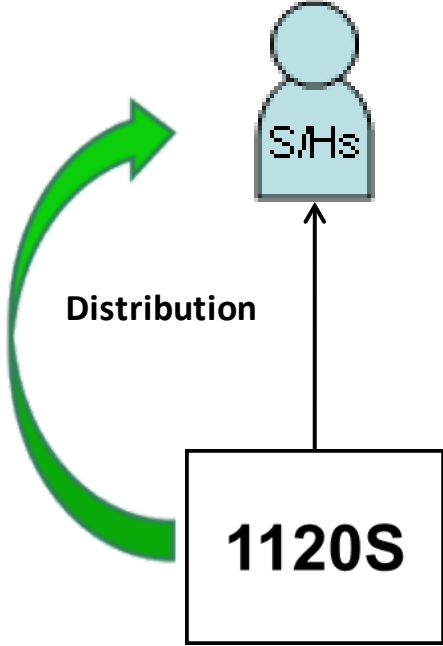
1. Decreased for non-dividend distributions to the extent of be
2. Increased for income items and excess depletion;
3. Decreased for non-deductible, non-capital expenses and depletion; and
4. Decreased for items of loss and deduction.



CAUTION: The distributions sourced from the beginning AAA will cause the AAA balance to become more negative. Any distributions in excess of the beginning AAA balance will not be sourced from AAA. The line items on Sch. M-2 do not follow the net negative adjustment AAA ordering rules; thus, the examiner needs to remember the above ordering rules when a net negative adjustment exists.

Transaction and Fact Pattern

Distributions with Accumulated Earnings & Profits

Diagram of Transaction	Facts
 <p>The diagram illustrates the flow of a distribution. A box labeled "1120S" (representing the S corporation) has an arrow pointing upwards to a person icon labeled "S/Hs" (representing the shareholder). A large green curved arrow labeled "Distribution" points from the "1120S" box back to the "S/Hs" icon, indicating the distribution of funds from the corporation to the shareholder.</p>	<ul style="list-style-type: none">▪ S corporation makes a distribution to the shareholder.▪ S corporation has AE&P.<ul style="list-style-type: none">- Form 1120S, Schedule M-2, line 1(c)▪ The S corporation should reflect the distribution on:<ul style="list-style-type: none">- Schedule K, line 16d (non-dividend) or 17c (dividend),- Schedule K-1, Box 16, Code D (non-dividend),- Schedule M-2, line 7 and- Schedule L, Balance Sheet, as a reduction of Retained Earnings, line 24.▪ If any amount of the distribution is a dividend, the S corporation should issue the shareholder a Form 1099-DIV for the dividend amount. <p>CAUTION: An S corporation may not properly report its amount of AE&P on Form 1120S, Schedule M-2, line 1(c). Even if reported, the amount of AE&P is allowed to be an estimate.</p>

Summary of Potential Issues

Distributions with Accumulated Earnings & Profits

<u>Issue 1</u>	In general, computing the amount of taxable dividend distributions.
<u>Issue 2</u>	More than one distribution and part of the distribution exceeds the AAA.
<u>Issue 3</u>	Elections effecting distributions.

All Issues, Step 1: Initial Factual Development

Distributions with Accumulated Earnings & Profits

Gather all the necessary facts to determine the correct amount of AE&P and AAA in order to properly compute the amount of dividend versus non-dividend distributions.

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Use the Reconciliation Workbook to verify the reliability of the tax return information as discussed in the <i>General Overview of Distributions and Accumulated Earnings & Profits</i> Practice Unit. 	<ul style="list-style-type: none"> ▪ Audit Tools - Reconciliation Workbook ▪ Practice Unit - <i>General Overview of Distributions and Accumulated Earnings & Profits</i>
<ul style="list-style-type: none"> ▪ Determine the amount of AE&P at the beginning of the exam year. Use the <i>General Overview of Distributions and Accumulated Earnings & Profits</i> Practice Unit to determine the existence of AE&P and compute or estimate the amount of AE&P. 	<p><i>Broadaway v. Comm’r</i> - 111 F.3d 593 (8th Cir. 1997)</p>
<ul style="list-style-type: none"> ▪ For purpose of verifying or recomputing AAA, review the current and previous year form 1120S returns to determine the corrected items of income, loss, deduction, non-deductible expenses and distribution for the current and all prior S corporation years. Corrected items include any adjustments to income, loss, deduction or distribution items through an amended return or as adjusted through an examination. 	<ul style="list-style-type: none"> ▪ yK1 ▪ IDRS ▪ IMS

Issue 1, Step 2: Review Potential Issues

Distributions with Accumulated Earnings & Profits

Issue 1

In general, computing the amount of taxable dividend distributions.

Explanation of Issue	Resources
<p>S corporations must properly compute AAA, PTI, AE&P and OAA in order to accurately source and report dividend versus non-dividend distributions to shareholders. If the S corporation does not report the dividend, then in most cases the shareholder will not pick up the proper amount of income on their return. The issue is to ensure that the dividend distribution is taxed at the proper time during the corporation's life cycle.</p> <p>The first step is to allocate the items of income, loss and deduction between AAA and OAA. The PTI and AE&P accounts are not affected by current year income, loss or deduction items. Most income, loss or deduction items included in the computation are reported on Schedule K. Some, however, are only reported on Schedule K-1 or an attachment to Schedule K-1. These should also be included in the computation. For instance, the sale or other disposition of property for which a section 179 expense deduction was previously passed through to its shareholders is reported on Schedule K-1, Box 17, Code K and should be included in the AAA computation.</p>	<ul style="list-style-type: none">▪ Audit Tool - S Corporation Distributions Issue Guide ▪ Form 1120S Instructions▪ IRC 179

Issue 1, Step 2: Review Potential Issues (cont'd)

Distributions with Accumulated Earnings & Profits

Issue 1

Explanation of Issue	Resources																																													
<p>This chart shows where the Schedule K items are reflected in the AAA, PTI, AE&P or OAA. Verify the AAA reported on the S corporation's Schedule M-2 is accurate. If it is not accurate, recompute AAA using the Schedules K beginning with the first S corporation year.</p> <div data-bbox="147 672 1344 1189" style="border: 1px solid black; padding: 10px;"> <p>Schedule M-2 Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account (see instructions)</p> <table border="1"> <thead> <tr> <th></th> <th>(a) Accumulated adjustments account</th> <th>(b) Shareholders' undistributed taxable income previously taxed</th> <th>(c) Accumulated earnings and profits</th> <th>(d) Other adjustments account</th> </tr> </thead> <tbody> <tr> <td>1 Balance at beginning of tax year</td> <td>\$0 first year of S corp</td> <td>Balance from pre-1983</td> <td>C corp earnings</td> <td>\$0 first year of S corp</td> </tr> <tr> <td>2 Ordinary income from page 1, line 21</td> <td>Sch K line 1 (if income)</td> <td></td> <td></td> <td></td> </tr> <tr> <td>3 Other additions</td> <td>Sch K line 2-10</td> <td></td> <td></td> <td>Sch K line 16a & 16b</td> </tr> <tr> <td>4 Loss from page 1, line 21</td> <td>(Sch K line 1 (if loss))</td> <td></td> <td></td> <td></td> </tr> <tr> <td>5 Other reductions</td> <td>(Sch K line 2-12d, 14l, 16c)</td> <td></td> <td></td> <td>(related to tax exempt)</td> </tr> <tr> <td>6 Combine lines 1 through 5</td> <td>Subtotal</td> <td>Subtotal</td> <td>Subtotal</td> <td>Subtotal</td> </tr> <tr> <td>7 Distributions</td> <td>Subtotal Sch K line 16d</td> <td>Sch K line 16d</td> <td>Sch K line 17c</td> <td>Sch K line 16d</td> </tr> <tr> <td>8 Balance at end of tax year. Subtract line 7 from 6</td> <td>Total</td> <td>Total</td> <td>Total</td> <td>Total</td> </tr> </tbody> </table> </div>		(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	\$0 first year of S corp	Balance from pre-1983	C corp earnings	\$0 first year of S corp	2 Ordinary income from page 1, line 21	Sch K line 1 (if income)				3 Other additions	Sch K line 2-10			Sch K line 16a & 16b	4 Loss from page 1, line 21	(Sch K line 1 (if loss))				5 Other reductions	(Sch K line 2-12d, 14l, 16c)			(related to tax exempt)	6 Combine lines 1 through 5	Subtotal	Subtotal	Subtotal	Subtotal	7 Distributions	Subtotal Sch K line 16d	Sch K line 16d	Sch K line 17c	Sch K line 16d	8 Balance at end of tax year. Subtract line 7 from 6	Total	Total	Total	Total	<ul style="list-style-type: none"> ▪ IRC 1368 ▪ Form 1120S Instructions ▪ Form 1120S
	(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	\$0 first year of S corp	Balance from pre-1983	C corp earnings	\$0 first year of S corp																																										
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7 Distributions	Subtotal Sch K line 16d	Sch K line 16d	Sch K line 17c	Sch K line 16d																																										
8 Balance at end of tax year. Subtract line 7 from 6	Total	Total	Total	Total																																										

Issue 1, Step 2: Review Potential Issues (cont'd)

Distributions with Accumulated Earnings & Profits

[Issue 1](#)

Explanation of Issue	Resources
<p>Once the allocation is made to AAA and OAA, the distributions can be sourced. Distributions are sourced first from AAA to the extent of positive AAA after considering the income, loss and deduction items for the year unless the net negative adjustment rule applies or an election discussed in Issue 3 is elected.</p> <p>To the extent the distributions are not sourced from AAA, the distributions are next sourced from PTI unless the election discussed in Issue 3 is made. The distributions are sourced from PTI to the extent of positive PTI.</p> <p>To the extent not sourced from PTI, the distributions are next sourced from AE&P to the extent of positive AE&P and reported as dividend distributions to the shareholders. Any distributions not sourced from AE&P, regardless of their sourcing, are reported as non-dividend distributions.</p>	

Issue 1, Step 2: Review Potential Issues (cont'd)

Distributions with Accumulated Earnings & Profits


[Issue 1](#)

Explanation of Issue	Resources
<p>To determine the amount of distributions reportable as dividends versus non-dividends, use the Distributions with AE&P Worksheet to source them from AAA, PTI, AE&P or OAA.</p> <div data-bbox="149 625 1282 932" style="border: 1px solid black; padding: 5px;"><p>Distributions from AAA to the extent of positive AAA after considering the income, loss and deduction items.</p><p style="text-align: center;">↓</p><p style="text-align: center;">PTI</p><p style="text-align: center;">↓</p><p style="text-align: center;">AE&P</p><p style="text-align: center;">↓</p><p style="text-align: center;">OAA</p></div>	

Issue 1, Step 3: Additional Factual Development

Distributions with Accumulated Earnings & Profits

Issue 1

Fact Element	Resources
<ul style="list-style-type: none">Review current and prior year returns for statements regarding reorganizations, liquidations and corporate division transactions that will impact the AE&P, AAA or PTI amounts. If an S corporation was previously a C corporation or received assets with a carryover basis from a C corporation, an amount should be included on Form 1120S, Schedule B lines 8 and 9. Also, review the balance sheet for any significant changes to owner's equity accounts to identify these transactions. Interview a corporate officer or review the board of director's minutes to verify your conclusions. <p> CAUTION: When a new S corporate entity is formed and a C corporation is merged into the S corporation in a tax-free transaction, the C corporation's AE&P carries over to the S corporation. However, the S corporation's date of incorporation and S election effective date remain the same. Review the newly formed S corporation's return for significant assets or sales. This may indicate a reorganization with a pre-existing entity.</p>	<ul style="list-style-type: none">EUPForm 1120S, Schedule B, lines 8 and 9
<ul style="list-style-type: none">Verify if any prior dividend distributions reported by the S corporation were actually reported as dividend distributions by the shareholder(s).	<ul style="list-style-type: none">EUPyK1

Issue 1, Step 4: Develop Arguments

Distributions with Accumulated Earnings & Profits

Issue 1

Explanation of Adjustment	Resources
<p>Correct the S corporation's AAA, OAA, AE&P, and PTI computation. Then reduce these accounts by the distribution (per ordering rules) to determine the correct amount of dividend versus non-dividend distribution required to be reported. The S corporation's AAA, OAA, AE&P, and PTI can be corrected for improper computations from prior years. Recompute AAA, OAA, AE&P and PTI if there were any errors identified in the computations in the current or prior years.</p> <ul style="list-style-type: none"> ▪ Common errors in the computation of AAA include failure to: <ul style="list-style-type: none"> – Use the amended or exam adjusted items of income, loss, deduction and distribution in the computation. – Reconcile AAA current year increases and decreases to Schedule K. These reconciliation errors may be caused by: <ul style="list-style-type: none"> ▪ Including book-tax differences in the AAA computation. ▪ Neglecting to reduce AAA by loss and deduction items. – Source distributions from AAA, OAA, AE&P, or PTI in prior years. – Account at the S corporation-level for the impact of any redemption, merger, acquisition, split-up or split-off transactions on the account balances. – Include tax-exempt income or expenses in AAA. – Consider the Net Negative Adjustment rule. – Reduce AAA for non-deductible expenses – Exclude from AAA disallowed losses such as from related party sales and distributions of property when the Fair Market Value (FMV) is less than the adjusted tax basis. 	<ul style="list-style-type: none"> ▪ Audit Tool - S Corporation Distributions Issue Guide ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide

Issue 2, Step 2: Review Potential Issues

Distributions with Accumulated Earnings & Profits

Issue 2

More than one distribution and part of the distribution exceeds the AAA.

Explanation of Issue	Resources
<p>When an S corporation makes multiple distributions during the year that exceed the AAA balance at the close of the tax year, then the AAA balance is allocated among the distributions in proportion to the distributions' respective sizes. Therefore, each distribution made during the year could be partially a non-dividend distribution from AAA and partially a taxable dividend distribution from AE&P. However, AE&P is not prorated among the distributions, rather each distribution to which AAA (or PTI) is not allocated is from AE&P until AE&P is exhausted.</p> <p>Further, the allocation of AAA among various distributions can affect the shareholder's timing of income recognition and the amount of tax owed if the:</p> <ul style="list-style-type: none"> ▪ S corporation is on a different year end from the shareholders, ▪ There are stock ownership changes during the year, ▪ Shareholders receive disproportionate distributions during the year, or ▪ The timing of distributions to each shareholder is different and AE&P will be exhausted. <p>For example, calendar-year shareholders of a fiscal-year S corporation may not know until the next year whether any of the current year's distributions are taxable because they are taxed on dividends in the year received. In this situation, an extension or amended return is required for the shareholder's income tax return.</p>	<ul style="list-style-type: none"> ▪ IRC 1368 ▪ Treas. Reg. 1.1368-2(b) ▪ IRC 1378 ▪ IRC 444 ▪ Treas. Reg. 1.301-1(b)

Issue 2, Step 3: Additional Factual Development

Distributions with Accumulated Earnings & Profits

[Issue 2](#)

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Determine if there is more than one distribution during the year and to whom the different distributions were made by reviewing the S corporation's General Ledger or through an interview of a corporate officer. The timing of each distribution to the different shareholders can make a tax difference even if the distributions are proportionate. Consider verifying the information by requesting the banking information for the timing of the distributions as appropriate. 	<ul style="list-style-type: none"> ▪ yK1 ▪ Form 1120S, Schedule K-1
<ul style="list-style-type: none"> ▪ Review the Schedules K-1 for a year over year percentage change in stock ownership. If there are distributions before and after a change in ownership then the computation of dividend versus non-dividend distributions is more complicated. Depending on how ownership changed (i.e. stock sale, stock redemption, etc.), consider consulting with a specialist. 	<ul style="list-style-type: none"> ▪ Form 1120S, Schedule K-1 ▪ yK1
<ul style="list-style-type: none"> ▪ Compare the shareholder's percentage of the total distributions for the year to the stock ownership percentages. If the percentages don't match, there is a distribution that is disproportionate to stock ownership. [Total distributions include the sum of dividend and non-dividend distributions reported on Schedule K.] 	<ul style="list-style-type: none"> ▪ Form 1120S, Schedule K ▪ Form 1120S, Schedule K-1
<ul style="list-style-type: none"> ▪ Review tax returns to determine if the S corporation and shareholder file using different fiscal year ends. 	<ul style="list-style-type: none"> ▪ yK1 ▪ EUP

Issue 2, Step 4: Develop Arguments

Distributions with Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources
<p>When an S corporation makes multiple distributions during the year that exceed the AAA balance at the close of the tax year, then the AAA balance is allocated among the distributions in proportion to the distributions' respective sizes. If you have determined the dividend versus non-dividend distributions will make a tax difference based upon one of the following circumstances:</p> <ul style="list-style-type: none">▪ The S corporation is on a different year end from the shareholders,▪ There are stock ownership changes during the year,▪ Shareholders receive disproportionate distributions during the year, or▪ AE&P will be exhausted and the timing of the distributions to the shareholders is different, then recompute the dividend versus non-dividend distribution allocation among the shareholders. <p>Note that S Corporations are required to have a single class of stock by IRC 1361(b)(1)(D). Generally, this means that each share of S Corporation has equal rights to receive distributions. If an S corporation makes distributions that are disproportionate with respect its stock, it may mean that the S Corporation has violated the single class of stock rule. Contact your local counsel if you identify such a situation.</p>	<ul style="list-style-type: none">▪ IRC 1361(b)(1)(D)

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

Distributions with Accumulated Earnings & Profits


Issue 2

Explanation of Adjustment	Resources																								
<p><u>Example 1 – Allocating AAA and AE&P to Multiple Distributions</u></p> <p>S corporation is owned 50-50 by shareholders A and B. The S corporation has \$3,000 of beginning AAA and earns \$7,000 of income. The S corporation has \$60,000 of AE&P and distributes \$80,000 cash to Shareholder A on 3/31 and \$20,000 cash to Shareholder B on 6/30.</p> <table border="1" data-bbox="265 733 1230 891"> <thead> <tr> <th></th> <th>Date</th> <th>Distribution</th> <th>AAA</th> <th>Dividend</th> <th>Return of Capital</th> </tr> </thead> <tbody> <tr> <td>Shareholder A</td> <td>3/31</td> <td>80,000</td> <td>8,000 (1)</td> <td>60,000 (3)</td> <td>12,000</td> </tr> <tr> <td>Shareholder B</td> <td>6/30</td> <td>20,000</td> <td>2,000 (2)</td> <td>0</td> <td>18,000</td> </tr> <tr> <td></td> <td></td> <td><u>100,000</u></td> <td><u>10,000</u></td> <td><u>60,000</u></td> <td><u>30,000</u></td> </tr> </tbody> </table> <p>(1) $80,000/100,000 \times 10,000 = 8,000$ (2) $20,000/100,000 \times 10,000 = 2,000$ (3) There is no rule that the AE&P be allocated proportionately to the distributions, so it is allocated to the distributions issued first until exhausted.</p> <p>AAA before distributions is computed as 10,000 [$10,000 = 3,000 + 7,000$]. The distribution is sourced \$10,000 as a non-dividend distribution and \$60,000 is a dividend distribution with the remaining \$30,000 being a return of capital. The AAA must be allocated to the shareholders in proportion to their distributions during the year. See the discussion on the previous slide with respect to the prohibition on multiple classes of stock.</p>		Date	Distribution	AAA	Dividend	Return of Capital	Shareholder A	3/31	80,000	8,000 (1)	60,000 (3)	12,000	Shareholder B	6/30	20,000	2,000 (2)	0	18,000			<u>100,000</u>	<u>10,000</u>	<u>60,000</u>	<u>30,000</u>	
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Issue 2, Step 4: Develop Arguments (cont'd)

Distributions with Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources
<p>Generally, S corporations and their shareholders will use a calendar year. Therefore, the year in which the dividend distribution is reported by the S corporation and the shareholder will be the same. However, an S corporation is allowed to have a different year end if it establishes a business purpose for the fiscal year to the satisfaction of the Secretary, or if the corporation elects a corporate year covered by IRC 444. The permitted year-ends for an IRC 444 election are September 30, October 31, or November 30.</p> <p>Whenever an S corporation and any shareholder have different year ends, determine the timing of the distributions. The year in which the dividend distribution takes place for the shareholder will determine the year in which it is includable in the shareholder's taxable income. This is correct even if the S corporation is unable to determine if the distribution is taxable as a dividend until the end of the S corporation's year.</p> <p>Adjust the shareholder's return for the proper year of dividend reporting. Note that the shareholder may have to file an amended return to report the dividend distribution.</p> <p> CAUTION: This Practice Unit does not address the impact on the allocation of dividend versus non-dividend distributions if there is a stock sale or stock redemption transaction during the year. Please contact the S Corporations & Cooperatives Practice Network if there are dividend and non-dividend distributions in the same year as a stock redemption transaction.</p>	<ul style="list-style-type: none">▪ IRC 444

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

Distributions with Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources																
<p data-bbox="84 496 845 529"><u>Example 2 – Fiscal Year Distributions Exceeding AAA</u></p> <p data-bbox="84 572 1384 644">S corporation's fiscal year ends October 31st. The shareholder is on a calendar year end of December 31st. For FY2 S corporation made the following distributions:</p> <table border="1" data-bbox="327 686 861 972"> <thead> <tr> <th data-bbox="333 696 422 729">Date</th> <th data-bbox="571 696 754 729">Distribution</th> </tr> </thead> <tbody> <tr> <td data-bbox="348 753 499 786">11-01-CY1</td> <td data-bbox="741 753 845 786">50,000</td> </tr> <tr> <td data-bbox="348 811 505 843">01-30-CY2</td> <td data-bbox="741 811 845 843">45,000</td> </tr> <tr> <td data-bbox="348 868 505 901">05-01-CY2</td> <td data-bbox="741 868 845 901">55,000</td> </tr> <tr> <td></td> <td data-bbox="706 925 845 958">\$150,000</td> </tr> </tbody> </table> <p data-bbox="84 1043 882 1076">At the end of FY2, the corporation showed the following:</p> <table border="1" data-bbox="277 1129 1100 1300"> <tbody> <tr> <td data-bbox="292 1139 882 1172">AAA at 10-31-FY2 Before Distributions</td> <td data-bbox="955 1139 1073 1172">100,000</td> </tr> <tr> <td data-bbox="292 1196 513 1229">AE&P</td> <td data-bbox="955 1196 1058 1229">20,000</td> </tr> <tr> <td data-bbox="292 1253 629 1286">Initial Stock Investment</td> <td data-bbox="955 1253 1073 1286">250,000</td> </tr> </tbody> </table>	Date	Distribution	11-01-CY1	50,000	01-30-CY2	45,000	05-01-CY2	55,000		\$150,000	AAA at 10-31-FY2 Before Distributions	100,000	AE&P	20,000	Initial Stock Investment	250,000	
Date	Distribution																
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Issue 2, Step 4: Develop Arguments (cont'd)

Distributions with Accumulated Earnings & Profits

[Issue 2](#)

Explanation of Adjustment	Resources																																			
<p><u>Example 2 – Fiscal Year Distributions Exceeding AAA (cont'd)</u></p> <p>Since the FY2 distributions exceeded the fiscal year-end AAA, AAA needs to be allocated based on the respective sizes of the distributions. The AAA is allocated as follows:</p> <table border="1" data-bbox="91 658 1272 876"> <thead> <tr> <th>Date</th> <th>Distribution</th> <th>AAA</th> <th></th> <th>Dividend</th> <th></th> <th>Return of Capital</th> </tr> </thead> <tbody> <tr> <td>11-01-CY1</td> <td>50,000</td> <td>33,333</td> <td>(1)</td> <td>16,667</td> <td>(3)</td> <td>0</td> </tr> <tr> <td>01-30-CY2</td> <td>45,000</td> <td>30,000</td> <td>(2)</td> <td>3,333</td> <td></td> <td>11,667</td> </tr> <tr> <td>05-01-CY2</td> <td><u>55,000</u></td> <td><u>36,667</u></td> <td></td> <td><u>0</u></td> <td></td> <td><u>18,333</u></td> </tr> <tr> <td></td> <td>150,000</td> <td>100,000</td> <td></td> <td>20,000</td> <td></td> <td>30,000</td> </tr> </tbody> </table> <p>(1) $50,000/150,000 \times 100,000 = 33,333$ (2) $45,000/150,000 \times 100,000 = 30,000$ (3) There is no rule that the AE&P be allocated proportionately to the distribution, so it is allocated to the distributions issued first until it is exhausted.</p> <p>The shareholders would have to report \$16,667 and \$3,333 of dividend income in CY1 and CY2, respectively.</p> <p>It should be noted that the shareholders will not know the amount of their CY1 dividend income until after FY2 closes when the S corporation's books are closed and the FY2 income tax return is completed. This would require the shareholders to estimate their FY1 dividend income when they file their CY1 return. They would then have to amend the CY1 return when the final figures are determined.</p>	Date	Distribution	AAA		Dividend		Return of Capital	11-01-CY1	50,000	33,333	(1)	16,667	(3)	0	01-30-CY2	45,000	30,000	(2)	3,333		11,667	05-01-CY2	<u>55,000</u>	<u>36,667</u>		<u>0</u>		<u>18,333</u>		150,000	100,000		20,000		30,000	
Date	Distribution	AAA		Dividend		Return of Capital																														
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Issue 3, Step 2: Review Potential Issues

Distributions with Accumulated Earnings & Profits

Issue 3

Elections effecting distributions.

Explanation of Issue	Resources
<p>The general sourcing rule is AAA, PTI, AE&P then OAA. However, an S corporation is allowed to make certain elections that will impact the general sourcing rule with the consent of all affected shareholders. The four elections are:</p> <ul style="list-style-type: none"> ▪ Election 1: Distribute AE&P Before AAA ▪ Election 2: Forego PTI ▪ Election 3: Deemed Dividend ▪ Election 4: Separate Tax Years <p>More than one election can be made in a given year. Each election is irrevocable once made and is effective only for the tax year of the election. There is no limit on the number of times an election can be made.</p> <p><u>Election 1: Distribute AE&P Before AAA</u></p> <p>An S corporation can elect to change the distribution sourcing rules to source distributions from AE&P before AAA. The election applies to all distributions for the year. The election does not provide that AE&P is distributed before PTI; therefore, the new sourcing of the distribution order is PTI, AE&P, AAA then OAA.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.1368-1(f)(2) ▪ Treas. Reg. 1.1368-1(f)(4) ▪ Treas. Reg. 1.1368-1(f)(3) ▪ Treas. Reg. 1.1368-1(g) ▪ Treas. Reg. 1.1368-1(f)(5)(iv) ▪ Treas. Reg. 1.1368-1(g)(2)(iii) ▪ IRC 1368(e)(3) ▪ Treas. Reg. 1.1368-1(f)(2)

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

Distributions with Accumulated Earnings & Profits

[Issue 3](#)

Explanation of Issue	Resources
<p><u>Election 2: Forego PTI</u></p> <p>An S corporation can elect to forego considering distributions from PTI. This is not the same as Election 1 where it is changing the ordering rules but rather the taxpayer does not consider PTI as a part of the computation. The election applies to all distributions for the year. This election by itself does not provide that AE&P is distributed before AAA; therefore, the ordering with the election is AAA, AE&P, OAA.</p> <p><u>Election 3: Deemed Dividend</u></p> <p>An S corporation that lacks the assets to make a distribution can make an election to deem a dividend distribution followed by a corresponding deemed capital contribution. The deemed dividend distribution amount is limited to the amount of AE&P after considering any actual distributions from AE&P. The deemed dividend distribution is allocated pro-rata to the shareholders according to their stock ownership.</p>	<ul style="list-style-type: none"><li data-bbox="1425 582 1819 615">▪ Treas. Reg. 1.1368-1(f)(4) <li data-bbox="1425 886 1819 919">▪ Treas. Reg. 1.1368-1(f)(3)

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

Distributions with Accumulated Earnings & Profits

[Issue 3](#)

Explanation of Issue	Resources
<p><u>Election 4: Separate Tax Years</u></p> <p>The S corporation can elect to have two separate tax years for purposes of making Elections 1-3 if there is a qualifying disposition during the year. Qualifying dispositions include (i) certain dispositions of 20% or more of the stock by a shareholder, (ii) certain redemption transactions and (iii) certain new stock issuances. Qualifying dispositions do not include a complete termination of the shareholder's interest in which case an election under IRC 1377(a)(2) and Treas. Reg. 1.1377-1(b) must be made. The election requires separate taxable years for purposes of allocating items of income and loss, making adjustments to AAA, earnings and profits, and basis.</p>	<ul style="list-style-type: none">▪ IRC 1377(a)(2)▪ Treas. Reg. 1.1377-1(b)▪ Treas. Reg. 1.1368-1(g)(ii)

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

Distributions with Accumulated Earnings & Profits

[Issue 3](#)

Explanation of Issue	Resources
<p><u>Who Must Consent to Each Election</u></p> <p>An S corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return. The election must receive consent from each “affected shareholder.” An affected shareholder is any shareholder to whom a distribution is made by the S corporation during the S corporation’s taxable year. For purposes of Election 4, the affected shareholders are all shareholders during the year. Therefore, all shareholders must consent.</p> <p><u>Statements Required to Be Attached to the Return</u></p> <ul style="list-style-type: none"> ▪ The S corporation must attach a statement to an original filed return (including extensions) or an amended return. The statement must identify the election, state the shareholder(s) consent to the election and signed under penalty of perjury by a corporate officer (note that signing the return suffices the penalty of perjury signature requirement). ▪ If Election 3, the deemed dividend election, is made, the statement must also include the amount of the deemed dividend allocated to each shareholder. ▪ If Election 4, separate tax years, is made, the statement must provide facts regarding the qualifying disposition. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.1368-1(f)(5) ▪ IRC 1368(e)(3) ▪ Treas. Reg. 1.1368-1(g)(iii) ▪ Treas. Reg. 1.1368-1(f)(5) ▪ Treas. Reg. 1.1368-1(g)(5) ▪ Treas. Reg. 1.1368-1(f)(5)(iii) ▪ Treas. Reg. 1.1368-1(g)(iii)

Issue 3, Step 3: Additional Factual Development

Distributions with Accumulated Earnings & Profits

[Issue 3](#)

Fact Element	Resources
▪ Review the S corporation tax return for any statements regarding elections.	▪ EUP
▪ Request a copy of the S corporation's work papers allocating AAA, PTI, AE&P and OAA to its various distributions if the Schedule M-2 is not reconcilable. Normally, it's easy to reconcile the Schedule M-2 to the return; however, certain corporate transactions can occur that make it irreconcilable. For example, if there is a redemption, liquidation, split-up, split-off, merger or acquisition transaction, obtain additional information and workpapers.	
▪ Request supporting documentation for the timing and amounts of any adjustments to AAA, PTI, AE&P, or OAA if the elections were part of a series of transactions that include a redemption, liquidation, split-up, split-off, merger or acquisition transaction.	

Issue 3, Step 4: Develop Arguments

Distributions with Accumulated Earnings & Profits

Issue 3

Explanation of Adjustment	Resources
<ul style="list-style-type: none"> Each of the elections can be made on an original filed return (including extensions) or an amended return. Therefore, the elections can be made during an examination. 	<ul style="list-style-type: none"> Audit Tool - S Corporation Distribution Issue Guide
<ul style="list-style-type: none"> An S corporation can make Election 1, Distribute AE&P before AAA, and Election 2, Forego PTI, in the same year causing distributions to be sourced from AE&P, AAA then OAA. There are a variety of reasons an S corporation may make the elections including trying to avoid the Tax on Excessive Net Passive Investment Income, expiring shareholder net operating losses requiring income to offset the loss, or the distribution will be in excess of stock basis. Therefore, the shareholder may prefer to reduce AE&P instead, among other reasons. 	<ul style="list-style-type: none"> Audit Tool - S Corporation Distribution Issue Guide Audit Tool - S Corporation Built-In Gains & Other Taxes Issue Guide
<ul style="list-style-type: none"> Election 1, Distribute AE&P before AAA, and Election 3, Deemed Dividend, are frequently requested on examinations when the issue involved is the tax on excessive net passive investment income, as the tax can result in a termination of the S election if there is excessive passive income and AE&P for 3 consecutive years. By making the election, the S corporation prevents the S election from terminating and reports a deemed dividend distribution in lieu of paying the additional tax on the passive investment income. An S corporation that does not have the cash to make the distributions may make Election 3 to: create basis to claim losses, to allow the shareholder to claim an expiring net operating losses, or because a new shareholder does not want AE&P and requires the old shareholder to recognize the dividend income. 	<ul style="list-style-type: none"> Audit Tool - S Corporation Built-In Gains & Other Taxes Issue Guide Audit Tool - S Corporation Distribution Issue Guide

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

Distributions with Accumulated Earnings & Profits

[Issue 3](#)

Explanation of Adjustment	Resources
<p><u>Example 3 – Elections to Avoid Net Passive Investment Income Tax</u></p> <p>At the end of CY3, S corporation has \$1 million of AE&P and \$5 million of AAA, and for years 1 through 4 the S corporation has passive income exceeding 25 percent of the corporation's gross receipts for each year as provided for under IRC 1375. The S corporation does not have PTI. The S corporation did not report the IRC 1375 tax in years 1 through 4 despite a legal requirement to do so.</p> <p>If the statute of limitation for assessment on year 3 is open, the taxpayer can file elections 1 and 3 to have a deemed dividend distribution of \$1 million effective on 12/31/CY3. The election eliminates the S corporation's AE&P and prevents the termination of the S corporation under IRC 1362(d)(3). The election has the effect of eliminating the IRC 1375 tax in years 3 and 4 and the S election won't terminate, but results in the shareholder reporting a \$1 million dividend distribution in CY3.</p> <p><u>Example 4 – Inadvertent Termination Relief and Elections</u></p> <p>Same facts as Example 3 except, if the statute of limitations for assessment on years 1 through 3 are closed, the S election will terminate on the first day of CY4. The taxpayer can request inadvertent termination relief through a Private Letter Ruling (PLR) to prevent the S election from terminating. The PLR may require the S corporation to pay any IRC 1375 taxes.</p>	<ul style="list-style-type: none">▪ IRC 1375 ▪ Treas. Reg. 1.1368-1(f)(2)▪ Treas. Reg. 1.1368-1(f)(3) ▪ IRC 1362(f)

Index of Referenced Resources

Distributions with Accumulated Earnings & Profits

IRC 179

IRC 312

IRC 444

IRC 1362

IRC 1363

IRC 1368

IRC 1371

IRC 1377

IRC 1378

IRC 1379

Treas. Reg. 1.301-1

Treas. Reg. 1.1368-1

Treas. Reg. 1.1368-2

Treas. Reg. 1.1377-1

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

Index of Referenced Resources

Form 1120S, Schedule K-1 - <i>Shareholder's Share of Income, Deductions, credits, etc. Form 1099-DIV</i>
Form 1120S Instructions
Form 1120S, Schedule K-1 Instructions

Training and Additional Resources

Distributions with 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 Distributions Issue Guide ▪ Audit Tool - S Corporation Corporate Issues & Advanced Topics Issue Guide ▪ Audit Tool - S Corporation Transactions with Shareholders Issue Guide ▪ Audit Tool - S Corporation Built-In Gains & Other Taxes Issue Guide
Databases/Research Tools	<ul style="list-style-type: none"> ▪ yK1 ▪ Employee User Portal (EUP) ▪ IDRS ▪ IMS
Reference Materials	<ul style="list-style-type: none"> ▪ <i>Practitioners Publishing Company (PPC) - 1120S Deskbook</i> ▪ <i>BNA Tax Management Portfolios U.S. Income Series Other Pass-through Entities 731 S Corporations: Operations IV. Treatment of S corporation Distributions</i>
Other Training Materials	<ul style="list-style-type: none"> ▪ Audit Tool - Reconciliation Workbook ▪ Audit Tool - Distributions with AE&P Worksheet

Glossary of Terms and Acronyms

Term/Acronym	Definition
AAA	Accumulated Adjustment Account
AE&P	Accumulated Earnings & Profits
CY	Calendar Year
EUP	Employee User Portal
FMV	Fair Market Value
FY	Fiscal Year
IDRS	Integrated Data Retrieval System
IMS	Issue Management System
OAA	Other Adjustments Account
PLR	Private Letter Ruling
PTI	Previously Taxed Income
yK1	yK1 Link Analysis Tool

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
01368	<i>General Overview of Distributions and Accumulated Earnings and Profits</i>
01368	<i>Property Distribution</i>
01368	<i>Taxability of Distributions Not From Accumulated Earnings & Profits</i>