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to:

(Small Business/Self-Employed)

Attn: _____, Attorney

from:

Bradford Poston

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(Passthroughs & Special Industries)

subject: Effect of § 311(a) Disallowed Losses on S Corporation Basis and AAA

This Chief Counsel Advice responds to an email request for assistance dated October 28, 2013. This advice may not be used or cited as precedent.

LEGEND

A =

B =

Date =

1

Date =

2

Date =

3

n =

o =

p =

ISSUE

Whether disallowed § 311(a) losses should reduce a shareholder's basis in S corporation stock, and whether the S corporation should reduce its accumulated adjustments account.

FACTS

The taxpayer, A, was formed as C corporation on Date 1. It elected S status on Date 2, and has been operating as an S corporation since that time. On Date 3, A redeemed transferred corporate-owned real estate to B, which is taxed as a partnership.¹ The real estate's net book value and tax adjusted basis was \$n; however, because of the economic recession at the time of the transfer the fair market value of the real estate was \$o. The shareholders did not reduce stock basis and A did not reduce its AAA by the \$p unrecognized losses attributable to the real estate transfer.

LAW

Section 311(a) provides that, except as provided in § 311(b), no gain or loss shall be recognized to a corporation on the distribution (not in complete liquidation) with respect to its stock of – (1) its stock (or rights to stock), or (2) property.

Section 1366(a)(1) provides that in determining the tax under Chapter 1 of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's--

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

Section 1367(a)(2) provides that the basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of § 1368,

¹ The title for the real estate passed directly from A to B. However, on its Form 1120S, A treated the transfer as a distribution of property to the shareholders who then contributed the property to B. The shareholders of A owned B in the same proportion. IRS Examination has not challenged this treatment of the distribution.

- (B) the items of loss and deduction described in subparagraph (A) of § 1366(a)(1),
- (C) any nonseparately computed loss determined under subparagraph (B) of § 1366(a)(1),
- (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and
- (E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under § 613A(c)(11)(B).

Section 1.1367-1(c)(2) provides that for purposes of § 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: Illegal bribes, kickbacks, and other payments not deductible under § 162(c); fines and penalties not deductible under § 162(f); expenses and interest relating to tax-exempt income under § 265; losses for which the deduction is disallowed under § 267(a)(1); the portion of meals and entertainment expenses disallowed under § 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under § 162.

Section 1368(a) provides that a distribution of property made by an S corporation with respect to its stock to which (but for § 1368(a)) § 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

Section 1368(b) provides that in the case of a distribution described in § 1368(a) by an S corporation which has no accumulated earnings and profits--(1) the distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock, (2) if the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

Section 1368(c) provides that In the case of a distribution described in § 1368(a) by an S corporation which has accumulated earnings and profits--(1) that portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b), (2) that portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation, (3) any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

Section 1368(d) provides that §§ 1368(b) and (c) shall be applied by taking into account (to the extent proper)— (1) the adjustments to the basis of the shareholder’s stock described in § 1367, and (2) the adjustments to the accumulated adjustments account which are required by § 1368(e)(1). In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of § 1367 (a) for the taxable year.

Section 1368(e)(1)(A) provides that the term “accumulated adjustments account” means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under § 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under title 26 and the phrase “(but not below zero)” shall be disregarded in § 1367 (a)(2)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

Section 1.1368-2(a)(3) provides that the AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year—

- (A) The items of loss or deduction described in § 1366(a)(1)(A);
- (B) Any nonseparately computed loss determined under § 1366(a)(1)(B);
- (C) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account, other than--
 - (1) Federal taxes attributable to any taxable year in which the corporation was a C corporation; and
 - (2) Expenses related to income that is exempt from tax; and
- (D) The sum of the shareholders’ deductions for depletion for any oil or gas property held by the corporation described in § 1367(a)(2)(E).

Section 1371(a) provides that except as otherwise provided in title 26, and except to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders.

ANALYSIS

The question posed here is whether a taxpayer’s disallowed § 311(a) losses should reduce a shareholder’s basis in S corporation stock, and whether the S corporation should reduce its accumulated adjustments account.

As a threshold matter, we note that § 311 does apply to S corporations because of § 1371(a), which states that the C corporation rules apply to S corporations unless they are inconsistent with subchapter S.²

² James S. Eustice & Joel D. Kuntz, *Federal Income Taxation of S Corporations*, at § 7.02 “Although an S corporation generally computes its gross income as an individual, such a corporation may, nevertheless, qualify under the nonrecognition rules in subchapter C that apply to corporations. Section 1371(a) provides that ‘subchapter C shall apply to an S corporation and its shareholders’ except to the extent that subchapter C is inconsistent with

Section 1367(a)(2)(D) provides that a non-deductible non-capital expense will reduce a shareholder's stock basis, but does not explicitly list § 311(a) losses as non-deductible non-capital expenses. Therefore, we must look to general tax policy and practical considerations to determine whether § 311(a) losses should reduce a shareholder's basis in S corporation stock and S corporation AAA.

The following simple examples illustrate how disallowed § 311(a) losses could be treated, and how that affects subsequent matters relating to the S corporation, the shareholder, or the distributed property. Shareholder is the sole shareholder of the S corporation.

Example

Shareholder forms S Corp in Year 1 by contributing Asset A worth \$1000. Shareholder has \$1000 basis in his stock, and S Corp has \$1000 basis in Asset A. In the hands of the S Corp, Asset A loses \$100 of value, and is now worth \$900. In Year 2, S Corp distributes Asset A, still worth \$900 to Shareholder. Shareholder's basis is reduced to \$100, and he takes Asset A with basis of \$900 (its FMV). If Shareholder is required to also reduce his basis for the disallowed § 311(a) loss, his new basis in S Corp is 0. Next, Shareholder liquidates S Corp. He received no proceeds since S Corp has no cash or other assets. If Shareholder is not required to reduce his basis by the disallowed § 311(a) loss, he has \$100 basis in his stock for which he receives a capital loss. Otherwise, he has no basis, and there is no tax effect to the liquidation of S Corp. Asset A's \$100 depreciation is lost.

COMPARE: If, rather than distributing the property directly to Shareholder, S Corp sold the property to a third party for \$900, S Corp would have a \$100 capital loss which would flow through to Shareholder, reducing his basis to \$900. Then S Corp could distribute the \$900 to Shareholder.

Secondary Sources

Most treatises state that § 311(a) losses reduce AAA and shareholder basis.

Samuel P. Starr & Horacio E. Sobol, 731-2nd T.M., S Corporations: Operations, at A-120:

In the case of a distribution of depreciated property, corporations are prohibited from recognizing loss under § 311(a). In PLR 8908016, an S corporation distributed appreciated and depreciated passive income property to reduce its exposure to a termination under § 1362(d)(2). The

subchapter S and except as otherwise provided in the Code. Thus, an S corporation should be able to avoid gross income under the following provisions in subchapter C. [For example], §§ 311(a) and 311(b) (distributions of a corporation's own obligation)."

IRS ruled that the distributing corporation would recognize gain under § 311(b) on the distribution of appreciated property but no loss would be recognized with respect to the depreciated property distributions. Further, the amount of the distribution was determined to be the total of any cash and the fair market value of any property distributed. Although not stated in the ruling, the AAA would be reduced by the fair market value of the distribution. In addition, the AAA would be decreased by any loss not allowable under § 311(a) with respect to the depreciated property.³

Analogy to Consolidated Returns

Section 1367(a)(2)(D) requires S corporation shareholders to reduce basis for nondeductible, noncapital expenses. We note that subchapter C does not have a concept of a nondeductible noncapital expense, but the investment adjustment regulations in subchapter A (consolidated returns) directly address the question.

The purpose of the investment adjustment rules is to treat the members of a consolidated group as a single entity so that consolidated taxable income reflects the group's income. Treas. Reg. §1.1502-32(a)(1). Thus, a member's basis in a subsidiary's stock is increased by positive adjustments and decreased by negative adjustments. Treas. Reg. §1.1502-32(b)(2). One of these negative adjustments is for noncapital, nondeductible expenses. Treas. Reg. §1.1502-32(b)(2)(iii).

The first two sentences of Treas. Reg. §1.1502-32(b)(3)(iii)(A) provide that:

In general, S's [a subsidiary's] noncapital, nondeductible expenses are its deductions and losses that are taken into account but permanently disallowed or eliminated under applicable law in determining its taxable income or loss, and that decrease, directly or indirectly the basis of its assets (or an equivalent amount). For example, S's Federal taxes described in section 275 and loss not recognized under section 311(a) are noncapital, nondeductible expenses.

Thus, a member's basis in its subsidiary stock is reduced by the amount of the section 311(a) loss. See, e.g., §1.1502-13(f)(7), Ex. 1(d).

Policy Considerations

³ See also James S. Eustice & Joel D. Kuntz, *Federal Income Taxation of S Corporations*, at § 8.03 ("If the corporation distributes property that is worth less than the basis . . . the corporation generally does not recognize the loss. Thus, no loss passes through to the shareholders. The shareholders obtain a step-down in basis without any compensating tax benefit."). Richard D. Blau, et al., *S Corporations Federal Taxation*, at § 10:9 (same). *Distributing Property to S Corporation Shareholders, Case Study*, *The Tax Adviser*, Albert B. Ellentuck, ed. Published April 1, 2011 (same). 1120S Deskbook, 20th Edition, Chapter 21G: *Distributing Property to Shareholders*. 20XX WL 1994353 (same). But see, Robert W. Jamison, *S Corporation Taxation* 461-62, 2013 edition ("[The] disallowed loss . . . does not reduce stock basis or AAA.").

Often, losses are delayed rather than permanently disallowed. For example, §§ 267(d), 336(d)(1), 465, 469, 704(d), and 1091 all restrict a taxpayer's ability to make an immediate use of a loss from an activity, but allow the loss to be used in the future under certain circumstances. However, sometimes losses are permanently disallowed, such as § 1.1366-2(a)(5)(i) (nontransferability of losses from a shareholder to another person). In the subchapter C context, § 311(a) is a permanent loss disallowance. Furthermore, § 1371 provides that subchapter C shall apply to an S corporation and its shareholders to the extent that it is consistent with subchapter S.

CONCLUSION

Disallowed § 311(a) losses will be treated as non-deductible, non-capital expenses pursuant to § 1367(a)(2)(D). Thus, a § 311(a) loss will reduce shareholders' bases in S corporation stock, and the S corporation must reduce its accumulated adjustments account.

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