

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201446021**

Release Date: 11/14/2014

CC:PSI:1
POSTU-127766-14

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 1368.01-00

date: July 23, 2014

to: Kathryn Patterson, Associate Area Counsel (Dallas) (LB&I)

from: Bradford Poston, Senior Counsel (CC:PSI:3)

subject:

This Chief Counsel Advice may not be used or cited as precedent.

LEGEND

X = EIN:

Date 1 =

Date 2 =

Date 3 =

Date 4 =

n =

o =

p =

q =

ISSUE

Does an S corporation's accumulated adjustments account survive beyond the post-termination transition period into a subsequent S period?

CONCLUSION

Section 1368(e)(2), which defines the term "S period" as the most recent continuous period during which the corporation has been an S corporation, requires that AAA be "reset" at the end of the PTTP. The AAA would thus be zero after the corporation re-elects S corporation status after an intervening C corporation period.

FACTS

The taxpayer, X, was incorporated as a C corporation on Date 1. It operated as a C corporation until it made its first election to be treated as an S corporation effective Date 2. At that time, the taxpayer had accumulated earnings and profits (E&P) of \$n. After its S election, the taxpayer continued to generate annual profits. The taxpayer had a AAA balance of \$o when its majority shareholders revoked its S election effective Date 3. During the PTTP, the taxpayer distributed \$p of its AAA to its shareholders pursuant to § 1371(e), leaving \$q of undistributed AAA related to its initial S period. The taxpayer represents that it did not distribute all of the AAA during the PTTP because it did not have the cash equal to its AAA to distribute. Furthermore, the taxpayer represents that it needed to retain cash to capitalize new market growth opportunities.

The taxpayer made another S election effective Date 4, and continues to operate as an S corporation today. The taxpayer represents that it converted from C to S to C and back to S to take advantage of individual and corporation tax rates available at the time of each conversion. The taxpayer requested a ruling regarding whether its AAA balance from its first S period (\$q) survived the period between the end of the PTTP and Date 4.

LAW AND ANALYSIS

An S corporation's AAA is an account of the S corporation not apportioned among the shareholders. All S corporations start with a AAA balance of zero on the first day of their S status. For S corporations with E&P from a prior period as a C corporation or a merger with a C corporation, the AAA tracks the corporation's ability to make tax free distributions to shareholders. To the extent that a corporation has a positive AAA, and the distribution does not exceed a shareholder's basis in the stock, the S corporation can make tax-free distributions to that shareholder.

When an S corporation's S status terminates it goes through a PTTP determined by § 1377(b)(1). During the PTTP the former S corporation can continue to take advantage of some of the benefits associated with its S status. Specifically, under § 1371(e), the shareholders will be able to make tax free distributions to the extent the corporation has a positive AAA balance.

Section 1371(e) provides that any distribution of money by a corporation with respect to its stock during a PTTTP shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the AAA (within the meaning of § 1368(e)). The question addressed by this memorandum is whether the AAA disappears forever after the PTTTP, or if it reappears upon a subsequent S election.

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 § 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 § 1368(b). (2) That portion of the distribution which remains after the application of § 1368(c)(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 § 1368(c)(2) shall be treated in the manner provided by § 1368(b). Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of § 1368(c), the balance of such account shall be allocated among such distributions in proportion to their respective sizes.

Section 1368(e)(1) defines the AAA as 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)(1) provides that on the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero.

Section 1368(e)(2) defines the term "S period" as the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

Section 1.1368-2(a)(2) provides that the AAA is increased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year: (i) The items of income described in § 1366(a)(1)(A) other than income that is exempt from tax; (ii) Any nonseparately computed income determined under § 1366(a)(1)(B); and (iii) The excess of the deductions for depletion over the basis of property subject to depletion unless the property is an oil or gas property the basis of which has been allocated to shareholders under § 613A(c)(11).

Section 1.1368-2(a)(3)(i) 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 1.1368-2(a)(3)(ii) provides that the AAA may be decreased below zero under § 1.1368-2(a)(3)(i). The AAA is decreased by noncapital, nondeductible expenses under § 1.1368-2(a)(3)(i)(C) even though a portion of the noncapital, nondeductible expenses is not taken into account by a shareholder under § 1.1367-1(g) (relating to the elective ordering rule). The AAA is also decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under § 1366(d)(1) or is otherwise not currently deductible under the Code. However, in any subsequent taxable year in which the loss, deduction, or noncapital, nondeductible expense is treated as incurred by the corporation with respect to the shareholder under § 1366(d)(2) or § 1.1367-1(g) (or in which the loss or deduction is otherwise allowed to the shareholder), no further adjustment is made to the AAA.

Section 1.1368-2(a)(3)(iii) provides that the AAA is decreased (but not below zero) by any portion of a distribution to which § 1368(b) or (c)(1) applies.

The concept of AAA was added to the Code as part of the 1982 Act. However, nothing in the legislative history from 1982 or subsequent revisions includes a more detailed definition of "S period" or indicates whether Congress intended the AAA to survive a break in S status.

When Congress enacted subchapter S in 1958, § 1375(d) referenced a concept similar to AAA called "undistributed taxable income previously taxed to shareholders" (PTI). The Senate Report accompanying the 1958 technical amendments, S. Rep. No. 85-1983, at 223 (1958), provided that:

Section 1375(d) of the new subchapter S provides rules whereby a shareholder's "net share of undistributed taxable income" of an electing small-business corporation for prior years may be distributed under regulations prescribed by the Secretary or his delegate, to such shareholder in a later year (with respect to which the election is still in effect) free of dividend consequences to the shareholder. . . . The term "all prior taxable years" does not include a taxable year to which the provisions of § 1375 do not apply and to taxable years prior to such year.

Thus, under § 1375(d)(2) a shareholder's net share of previously taxed undistributed taxable income is computed by first determining the total amount of the corporation's undistributed taxable income which has been actually included in his gross income for all his prior taxable years in which or with which ended a taxable year of the corporation with respect to which an election was in effect, excluding any taxable year prior to a break in the election. . . .

It will be noted that under new § 1375(d) an individual who becomes a shareholder in an electing small business corporation will not be entitled to the benefits of § 1375(d) until, at the earliest, the year following a year in which he has included in his gross income a share of the corporation's undistributed taxable income and then only to the extent, at most, of his share of such undistributed taxable income. However, if such an individual was formerly a stockholder in the corporation during a taxable year as to which it was an electing small business corporation and the election has been in effect continually since such previous year, he would be entitled to the benefits of § 1375(d) with respect to distributions not in excess of amounts of undistributed taxable income of the corporation included in his gross income for such previous year. (Emphasis added.)

The emphasized portions of the legislative history quoted above seem to indicate Congress' intention that the undistributed taxable income expire at the end of any given S period. Specifically, this is evident where the Senate Report refers to years "prior to a break in the election" and the requirement that the election be in effect "continually."¹

We understand that some taxpayers may argue that §§ 1368(e)(1) and (2) should be read in conjunction with one another. Section 1368(e)(1) provides that AAA is adjusted for the S period in a manner similar to the adjustments under § 1367 and that no adjustment will be made for federal taxes attributable to any taxable year in which the corporation was a C corporation. Section 1368(e)(2) defines "S period" as the most recent continuous period during which the corporation has been an S corporation.

¹ Despite their similarities, however, PTI and AAA have notable differences. Specifically, PTI was a shareholder account that could not be transferred. Conversely AAA is a corporate account, and when a shareholder transfers stock to another person, distributions made to the shareholders including the transferee are governed by the corporate account and not with reference to the transferor.

Reading §§ 1368(e)(1) and (2) together, one could argue that the statute merely intends that the corporation's AAA will not be adjusted during any period that the corporation is not an S corporation. However, we believe this reading is overly narrow. If AAA survives the PTTP, but may not be adjusted during the C corporation period under § 1368(e), certain events, such as redemptions, occurring while the taxpayer is a C corporation may economically require the adjustments forbidden by the statute, leading to distortions.

Additionally, a shareholder's outside basis in his S corporation stock generally will reflect taxable income of the corporation while it is an S corporation, and that outside basis will not disappear when the S corporation status changes. Even though, at first blush, it might appear that a corporation that fails to distribute its AAA during the PTTP will lose the ability to make tax-free distributions of previously taxed income when it re-elects S corporation status in a subsequent period, we do not believe this is the case. Rather, the corporation retains the ability to make tax-free distributions from the shareholder's outside basis, it simply must distribute out of its E&P first. Thus, we believe the question becomes one of a timing difference, not a permanent difference in the taxability of corporate distributions.

Finally, the plain language of the statute states that the AAA will reset to zero when the PTTP ends. Section 1368(e)(2) defines the "S period" as the most recent continuous period during which the corporation has been an S corporation. (Emphasis added.) Section 1.1368-2(a)(1) states that on the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero. We also note that because the statute specifically grants a PTTP, this implies that the PTTP is the only time the corporation may draw down its AAA by making distributions after termination of S corporation status.

Therefore, we conclude that an S corporation's AAA is reset to zero after the PTTP and remains zero into a subsequent S period.

Please call (202) 317-6850 if you have any further questions.