

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals \$9,000. Thus, the basis of Debt No. 3 is restored by \$3,200 (the amount of the previous reduction) to \$4,000. A's basis in Debt No. 3 is treated as restored immediately before that debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of \$1,300 (\$4,500 - \$3,200) is applied to restore the bases of Debt No. 1 and Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is \$5,800 (\$9,000 - \$3,200). The basis of Debt No. 1 is restored in an amount equal to \$224 (\$1,300 × \$1,000/\$5,800). Similarly, the basis in Debt No. 2 is restored in an amount equal to \$1,076 (\$1,300 × \$4,800/\$5,800). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

Original basis	Amount reduced	1/1/98 basis	Amount restored	12/31/98 basis
\$1,000	\$1,000	\$0	\$224	\$224
5,000	4,800	200	1,076	1,276

Example 3. Full restoration of basis in indebtedness when debt is repaid in part during the taxable year. (i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S \$1,000. S issues its note to C in the amount of \$1,000, of which \$950 is payable on March 1, 1998, and \$50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to \$900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is \$300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under § 1.1367-2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or \$1,000. Therefore, \$100 of the \$300 net increase is applied to restore the basis of the debt from \$900 to \$1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of \$200 increases C's basis in her stock.

Example 4. Determination of net increase—distribution in excess of increase in basis. (i) D has been the sole shareholder in Corporation

S since 1990. On January 1, 1996, D loans S \$10,000 in return for a note from S in the amount of \$10,000 of which \$5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to \$8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals \$10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals \$0. During 1998, S also makes distributions to D totaling \$11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and must be taken into account for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The \$10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the \$11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to \$0. See section 1368 and § 1.1368-1 (c) and (d) for the tax treatment of the \$1,000 distribution in excess of D's basis.

Example 5. Distributions less than increase in basis. (i) The facts are the same as in *Example 4*, except that in 1998 S makes distributions to D totaling \$8,000. On these facts, for 1998, there is a net increase with respect to D of \$2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of \$2,000 with respect to D for 1998, \$2,000 of the \$10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to \$10,000 (\$8,000 + \$2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of \$0 (\$0 + \$8,000 (increase in basis remaining after restoring basis in indebtedness) - \$8,000 (distribution)) and a basis in the note of \$10,000.

[T.D. 8508, 59 FR 16, Jan. 3, 1994]

§ 1.1367-3 Effective date and transition rule.

Except for § 1.1367-1(f), (h) *Example 2* and *Example 5*, and (j), §§ 1.1367-1 and 1.1367-2 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1367-1(f), (h) *Example 2* and *Example 5*, and (j) apply

only to taxable years of the corporation beginning on or after August 18, 1998. For taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998, the basis of a shareholder's stock must be determined in a reasonable manner, taking into account the statute and legislative history. Except for § 1.1367-1(f), (h) *Example 2* and *Example 5*, and (j), return positions consistent with §§ 1.1367-1 and 1.1367-2 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with § 1.1367-1(f), (h) *Example 2* and *Example 5*, and (j) are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

[T.D. 8852, 64 FR 71649, Dec. 22, 1999]

§ 1.1368-0 Table of contents.

The following table of contents is provided to facilitate the use of §§ 1.1368-1 through 1.1368-4.

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(2) Election in case of a qualifying disposition.

- (i) In general.
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§ 1.1368-2 Accumulated adjustments account (AAA).

- (a) Accumulated adjustments account.
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 - (e) Election to terminate year under section 1377(a)(2) or § 1.1368-1(g)(2).

§ 1.1368-3 Examples.

§ 1.1368-4 Effective date and transition rule.

[T.D. 8508, 59 FR 18, Jan. 3, 1994, as amended by T.D. 8696, 61 FR 67455, Dec. 23, 1996; T.D. 8852, 64 FR 71649, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368-1 Distributions by S corporations.

- (a) *In general.* This section provides rules for distributions made by an S corporation with respect to its stock which, but for section 1368(a) and this section, would be subject to section 301(c) and other rules of the Internal Revenue Code that characterize a distribution as a dividend.
- (b) *Date distribution made.* For purposes of section 1368, a distribution is