AAA allocated to a distribution under this section must be further allocated (under paragraph (c)(2) of this section) if the distribution—

(i) Consists of property the adjusted basis of which exceeds its fair market value on the date of the distribution and money;

(ii) Is a distribution to which § 1.1368–1(d)(1) applies; and

(iii) Exceeds the amount of the corporation's AAA properly allocable to that distribution.

(2) *Allocating the AAA to loss property.* The amount of the AAA allocated to the property other than money is equal to the amount of the AAA allocated to the distribution multiplied by a fraction, the numerator of which is the fair market value of the property other than money on the date of distribution and the denominator of which is the amount of the distribution. The amount of the AAA allocated to the money is equal to the amount of the AAA allocated to the distribution reduced by the amount of the AAA allocated to the property other than money.

(d) *Adjustment in the case of redemptions, liquidations, reorganizations, and divisions*—(1) *Redemptions*—(i) *General rule.* In the case of a redemption distribution by an S corporation that is treated as an exchange under section 302(a) or section 303(a) (a *redemption distribution*), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

(ii) *Special rule for years in which a corporation makes both ordinary and redemption distributions.* In any year in which a corporation makes one or more distributions to which section 1368(a) applies (*ordinary distributions*) and makes one or more redemption distributions, the AAA of the corporation is adjusted first for any ordinary distributions and then for any redemption distributions.

(iii) *Adjustments to earnings and profits.* Earnings and profits are adjusted under section 312 independently of any adjustments made to the AAA.

(2) *Liquidations and reorganizations.* An S corporation acquiring the assets of another S corporation in a transaction to which section 381(a) applies will succeed to and merge its AAA (whether positive or negative) with the AAA (whether positive or negative) of the distributor or transferor S corporation as of the close of the date of distribution or transfer. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior to the transaction.

(3) *Corporate separations to which section 368(a)(l)(D) applies.* If an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(l)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under section 312 (h). See § 1.312–10(a).

(e) *Election to terminate year under section 1377(a)(2) or § 1.1368–1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of termination of a shareholder's interest) or § 1.1368–1(g)(2) (to terminate the year in the case of a qualifying disposition), this section applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder terminated his or her interest in the corporation or makes a substantial disposition of stock, whichever the case may be.

[T.D. 8508, 59 FR 20, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999; T.D. 8869, 65 FR 3855, Jan. 25, 2000]

§ 1.1368–3 Examples.

The principles of §§ 1.1368–1 and 1.1368–2 are illustrated by the examples below. In each example Corporation S is a calendar year corporation:

Example 1. Distributions by S corporations without C corporation earnings and profits for *taxable years beginning before January 1, 1997.* (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 1996, the first day of its 1996 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 1996, S makes a distribution of $38 to A. For S's 1996 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50 and A's pro rata share of the amount of the items described in section 1367(a)(2) (B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26.

(ii) Under section 1368(d)(1) and § 1.1368–1(e)(1), the adjustments to the bases of A's stock in S described in section 1367 are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $3.40 ($1 + [($50–$26) / 10 shares]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under § 1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution / 10 shares). However, A only has a basis of $3.40 in each share, and basis may not be reduced below zero. Therefore, the basis of each share of his stock is reduced by $3.40 to zero, and the remaining $4.00 of the distribution ([$3.80–$3.40] × 10 shares) is treated as gain from the sale or exchange of property. As of January 1, 1997, A has a basis of $0 in his shares of S stock.

Example 2. Distributions by S corporations without earnings and profits for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has no earnings and profits as of January 1, 2001, the first day of its 2001 taxable year. S's sole shareholder, A, holds 10 shares of S stock with a basis of $1 per share as of that date. On March 1, 2001, S makes a distribution of $38 to A. The balance in Corporation S's AAA is $100. For S's 2001 taxable year, A's pro rata share of the amount of the items described in section 1367(a)(1) (relating to increases in basis of stock) is $50. A's pro rata share of the amount of the items described in sections 1367(a)(2)(B) through (D) (relating to decreases in basis of stock for items other than distributions) is $26, $20 of which is attributable to items described in section 1367(a)(2)(B) and (C) and $6 of which is attributable to items described in section 1367(a)(2)(D) (relating to decreases in basis attributable to noncapital, nondeductible expenses).

(ii) Under section 1368(d)(1) and § 1.1368–1(e)(1) and (2), the adjustments to the basis of A's stock in S described in sections 1367(a)(1) are made before the distribution rules of section 1368 are applied. Thus, A's basis per share in the stock is $6.00 ($1 + [$50/10]) before taking into account the distribution. Under section 1367(a)(2)(A), the basis of A's stock is decreased by distributions to A that are not includible in A's income. Under § 1.1367–1(c)(3), the amount of the distribution that is attributable to each share of A's stock is $3.80 ($38 distribution/10 shares). Thus, A's basis per share in the stock is $2.20 ($6.00–$3.80), after taking into account the distribution. Under section 1367(a)(2)(D), the basis of each share of A's stock in S after taking into account the distribution, $2.20, is decreased by $.60 ($6 noncapital, nondeductible expenses/10). Thus, A's basis per share after taking into account the nondeductible, noncapital expenses is $1.60. Under section 1367(a)(2)(B) and (C), A's basis per share is further decreased by $2 ($20 items described in section 1367(a)(2)(B) and (C)/10 shares). However, basis may not be reduced below zero. Therefore, the basis of each share of A's stock is reduced to zero. As of January 1, 2002, A has a basis of $0 in his shares of S stock. Pursuant to section 1366(d)(2), the $.40 of loss in excess of A's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to A.

Example 3. Distributions by S corporations with C corporation earnings and profits for taxable years beginning before January 1, 1997. (i) Corporation S properly elects to be an S corporation beginning January 1, 1997, and as of that date has accumulated earnings and profits of $30. B, an individual and sole shareholder of Corporation S, has 10 shares of S stock with a basis of $12 per share. In addition, B lends $30 to S evidenced by a demand note.

(ii) During 1997, S has a nonseparately computed loss of $150. S makes no distributions to B during 1997. Under section 1366(d)(1), B is allowed a loss equal to $150, the amount equal to the sum of B's bases in his shares of stock and his basis in the debt. Under section 1367, the loss reduces B's adjusted basis in his stock and debt to $0. Under § 1.1368–2(a)(3), S's AAA as of December 31, 1997, has a deficit of $150 as a result of S's loss for the year.

(iii) For 1998, S has $220 of separately stated income and distributes $110 to B. The balance in the AAA (negative $150 from 1997) is increased by $220 for S's income for the year and decreased to $0 for the portion of the distribution that is treated as being from the AAA ($70). Under § 1.1367–2(c), B's net increase is $150, determined by reducing the $220 of income by the $70 of the distribution not includible in income by B. Thus, B's basis in the debt is fully restored to $30, and B's basis in S stock (before accounting for the distribution) is increased from zero to $19 per share ([$220–$30 applied to the debt] / 10). Thirty dollars of the distribution is considered a dividend to the extent of S's $30 of earnings and profits, and the remaining $10 of the distribution reduces B's basis in the S stock. Thus, B's basis in the S stock as of December 31, 1998, is $11 per share ($19–[$70 AAA distribution / 10]–[10 distribution treated as a reduction in basis / 10]). The balance in the AAA is $0, S's earnings and profits are $0, and B's basis in the loan is $30.

Example 4. Distributions by S corporations with earnings and profits and no net negative adjustment for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $1,500 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $1,500. For the taxable year ending December 31, 2001, S does not have a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and § 1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from $2,000 to $4,000 for the $2,000 of income earned during the 2001 taxable year. The AAA is decreased from $4,000 to $2,500 for the $1,500 of losses. The AAA is decreased from $2,500 to $1,000 for the portion of the distribution ($1,500) to B that does not exceed the AAA.

(iii) As of December 31, 2001, B's basis in his stock is $10 ($20 + $20 ($2,000 income/100 shares)—$15 ($1,500 distribution/100 shares)—$15 ($1,500 loss/100 shares).

Example 5. Distributions by S corporations with earnings and profits and net negative adjustment for taxable years beginning on or after August 18, 1998. (i) Corporation S, an S corporation, has accumulated earnings and profits of $1,000 and a balance in the AAA of $2,000 on January 1, 2001. S's sole shareholder B holds 100 shares of stock with a basis of $20 per share as of January 1, 2001. On April 1, 2001, S makes a distribution of $2,000 to B. B's pro rata share of the income earned by S during 2001 is $2,000 and B's pro rata share of S's losses is $3,500. For the taxable year ending December 31, 2001, S has a net negative adjustment as defined in section 1368(e)(1)(C). S does not make the election under section 1368(e)(3) and § 1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The AAA is increased from $2,000 to $4,000 for the $2,000 of income earned during the 2001 taxable year. Because under section 1368(e)(1)(C)(ii) and § 1.1368–2(a)(ii), the net negative adjustment is not taken into account, the AAA is decreased from $4,000 to $2,000 for the portion of the losses ($2,000) that does not exceed the income earned during the 2001 taxable year. The AAA is reduced from $2,000 to zero for the portion of the distribution to B ($2,000) that does not exceed the AAA. The AAA is decreased from zero to a negative $1,500 for the portion of the $3,500 of loss that exceeds the $2,000 of income earned during the 2001 taxable year.

(iii) Under § 1.1367–1(c)(1), the basis of a shareholder's share in an S corporation stock may not be reduced below zero. Accordingly, as of December 31, 2001, B's basis per share in his stock is zero ($20 + $20 income—$20 distribution—$35 loss). Pursuant to section 1366(d)(2), the $15 of loss in excess of B's basis in each of his shares of S stock is treated as incurred by the corporation in the succeeding taxable year with respect to B.

Example 6. Election in case of disposition of substantial amount of stock. (i) Corporation S, an S corporation, has earnings and profits of $3,000 and a balance in the AAA of $1,000 on January 1, 1997. C, an individual and the sole shareholder of Corporation S, has 100 shares of S stock with a basis of $10 per share. On July 3, 1997, C sells 50 shares of his S stock to D, an individual, for $250. For 1997, S has taxable income of $1,000, of which $500 was earned on or before July 3, 1997, and $500 earned after July 3, 1997. During its 1997 taxable year, S distributes $1,000 to C on February 1 and $1,000 to each of C and D on August 1. S does not make the election under section 1368(e)(3) and § 1.1368–1(f)(2) to distribute its earnings and profits before its AAA. S makes the election under § 1.1368–1(g)(2) to treat its taxable year as if it consisted of separate taxable years, the first of which ends at the close of July 3, 1997, the date of the qualifying disposition.

(ii) Under section § 1.1368–1(g)(2), for the period ending on July 3, 1997, S's AAA is $500 ($1,000 (AAA as of January 1, 1997) + $500 (income earned from January 1, 1997 through July 3, 1997)–$1,000 (distribution made on February 1, 1997)). C's bases in his shares of stock is decreased to $5 per share ($10 (original basis) + $5 (increase per share for income)–$10 (decrease per share for distribution)).

(iii) The AAA is adjusted at the end of the taxable year for the period July 4 through December 31, 1997. It is increased from $500 (AAA as of the close of July 3, 1997) to $1,000 for the income earned during this period and is decreased by $1,000, the portion of the distribution ($2,000 in total) made to C and D on August 1 that does not exceed the AAA. The $1,000 portion of the distribution that remains after the AAA is reduced to zero is attributable to earnings and profits. Therefore C and D each have a dividend of $500, which does not affect their basis or S's AAA. The earnings and profits account is reduced from $3,000 to $2,000.

(iv) As of December 31, 1997, C and D have bases in their shares of stock of zero ($5 (basis as of July 4)+$5 ($500 income/100 shares)–$10 ($1,000 distribution/100 shares)). C and D each will report $500 as dividend income, which does not affect their basis or S's AAA.

Example 7. Election to distribute earnings and profits first. (i) Corporation S has been a calendar year C corporation since 1975. For 1982, S elects for the first time to be taxed under subchapter S, and during 1982 has $60 of earnings and profits. As of December 31, 1995, S has an AAA of $10 and earnings and profits of $160, consisting of $100 of subchapter C earnings and profits and $60 of subchapter S earnings and profits. For 1996, S has $200 of taxable income and the AAA is increased to $210 (before taking distributions into account). During 1996, S distributes $240 to its shareholders. With its 1996 tax return, S properly elects under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) Because S elected to distribute its earnings and profits before its AAA, the first $100 of the distribution is characterized as a distribution from subchapter C earnings and profits; the next $60 of the distribution is characterized as a distribution from subchapter S earnings and profits. Because $160 of the distribution is from earnings and profits, the shareholders of S have a $160 dividend. The remaining $80 of the distribution is a distribution from S's AAA and is treated by the shareholders as a return of capital or gain from the sale or exchange of property, as appropriate, under §1.1368–1(d)(1). S's AAA, as of December 31, 1996, equals $130 ($210–$80).

Example 8. Distributions in excess of the AAA. (i) On January 1, 1995, Corporation S has $40 of earnings and profits and a balance in the AAA of $100. S has two shareholders, E and F, each of whom own 50 shares of S's stock. For 1995, S has taxable income of $50, which increases the AAA to $150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $60 to each shareholder. On September 1, 1995, S distributes $30 to each shareholder. S does not make the election under section 1368(e)(3) and §1.1368–1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The sum of the distributions exceed S's AAA. Therefore, under §1.1368–2(b), a portion of S's $150 balance in the AAA as of December 31, 1995, is allocated to each of the February 1 and September 1 distributions based on the respective sizes of the distributions. Accordingly, S must allocate $100 ($150 (AAA)×($120 (February 1 distribution)/$180 (the sum of the distributions))) of the AAA to the February 1 distribution, and $50 ($150×($60/$180)) to the September 1 distribution. The portions of the distributions to which the AAA is allocated are treated by the shareholder as a return of capital or gain from the sale or exchange of property, as appropriate. The remainder of the two distributions is treated as a dividend to the extent that it does not exceed S's earnings and profits. E and F must each report $10 of dividend income for the February 1 distribution. For the September 1 distribution, E and F must each report $5 of dividend income.

Example 9. Ordinary and redemption distributions in the same taxable year. (i) On January 1, 1995, Corporation S, an S corporation, has $20 of earnings and profits and a balance in the AAA of $10. S has two shareholders, G and H, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of $16, which increases the AAA to $26 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes $10 to each shareholder. On December 31, 1995, S redeems for $13 all of shareholder G's stock in a redemption that is treated as a sale or exchange under section 302(a).

(ii) The sum of the ordinary distributions does not exceed S's AAA. Therefore, S must reduce the $26 balance in the AAA by $20 for the February 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or gain from the sale or exchange of property. S must adjust the remaining AAA, $6, in an amount equal to the ratable share of the remaining AAA attributable to the redeemed stock, or $3 (50%×$6).

(iii) S also must adjust the earnings and profits of $20 in an amount equal to the ratable share of the earnings and profits attributable to the redeemed stock. Therefore, S adjusts the earnings and profits by $10 (50%×$20), the ratable share of the earnings and profits attributable to the redeemed stock.

[T.D. 8508, 59 FR 22, Jan. 3, 1994; 59 FR 10675, Mar. 7, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999]

§ 1.1368–4 Effective date and transition rule.

Except for §§1.1368–1(e)(2), 1.1368–2(a)(5), and 1.1368–3 *Example 2*, *Example 4*, and *Example 5*, §§1.1368–1, 1.1368–2, and 1.1368–3 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1368–1(e)(2), §1.1368–2(a)(5), and §1.1368–3 *Example 2*, *Example 4*, and *Example 5* 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 treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account