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 case may be.


§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. 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) (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 $50. 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 $6.00 ($1 + ($50/10)) before taking into account the distribution. Under section 1368(d)(1), 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 A’s 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, 1996. (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 $50. 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 $6.00 ($1 + ($50/10)) before taking into account the distribution. Under section 1367(a)(2)(B), the basis of A’s stock before the distribution 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 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 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 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 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 is $2.20 ($6.00–$3.80). Thus, A’s basis per share after taking into account the noncapital expenses is $1.60. As of January 1, 2002, A has a basis of $0 in his shares of S stock. Pursuant to section 1366(d)(2), the $4.00 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, holds 100 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 1368(e)(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, 1997. 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)

(ii) The AAA is increased from $0 to a negative $1,500 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 losses/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 1366(d)(2), the $15 of loss in excess of earnings and profits before its AAA ($70). Under §1.1367–2(a)(ii), the net negative adjustment is not taken into account, the AAA is decreased from $1,000 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.
AAA. S makes the election under §1.1368-
(1)(g)(2) to treat its taxable year as if it con-
sisted 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 pe-
riod ending on July 3, 1997, S’s AAA is $500
($1,000 (AAA as of January 1, 1997) + $500 (in-
come for the period January 1 through July 3,
1997)−$1,000 (distribution made on Feb-
ruary 1, 1997)). C’s bases in his shares of
stock is decreased to $5 per share ($10 (ori-
ginal basis) + $5 (increase per share for in-
come)−$10 (decrease per share for distribu-
tion)).
(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
(1996 tax return, S properly
reports as a return of capital or gain
from the sale or exchange of property, as ap-
propriate). The remainder of the two distribu-
tions 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 Decem-
brary 31, 1996, equals $130 ($210−$80).
Example 8. Distributions in excess of the AAA.
(i) On January 1, 1995, Corporation S, an S cor-
nporation, elects under section 1368(e)(3) and § 1.1368–
1(f)(2) to distribute its 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 distribu-
tions made during 1995). On February 1, 1995,
S distributes $90 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.
(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
(1996 tax return, S properly
reports as a return of capital or gain
from the sale or exchange of property, as ap-
propriate). The remainder of the two distribu-
tions 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 Decem-

Example 7. Election to distribute earnings and
profits first. (i) Corporation S has been a cal-
endar year C corporation since 1975. For 1982,
S elects for the first time to be taxed under
subchapter S, and during 1982 has $90 of earn-
ings and profits. As of December 31, 1985, S
has an AAA of $10 and earnings and profits of
$100, consisting of $100 of subchapter C earn-
ings and profits and $60 of subchapter S earn-
ings and profits. For 1996, S has $200 of tax-
able income and the AAA is increased to $210
(before taking distributions into account).
During 1996, S distributes $240 to its share-
holders. 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 charac-
terized as a distribution from sub-
chapter S earnings and profits. Because $160
of the distribution is from earnings and prof-
its, the shareholders of S have a $160 divi-
dend. 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 9. Ordinary and redemption distribu-
tions 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 $210 as of December 31,
1995 (before taking into account distribu-
tions made during 1995). On February 1, 1995,
S distributes $90 to each shareholder. On
November 1, 1995, G redeems 50 of his shares of
S’s stock for $13, which reduces the AAA to
$10 as of the close of December 31, 1995.
(ii) The sum of the distributions exceeds S’s
AAA, as of December 31, 1995, equals $200
($90 + $90 + $13). Therefore, under §1.1368–2(b),
a portion
of S’s $200 balance in the AAA as of Decem-

812
§ 1.1368–3
26 CFR Ch. I (4–1–09 Edition)
(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.


§ 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 the statute and legislative history. Except with regard to the deemed dividend rule under § 1.1368–1(f)(3), §§ 1.1368–1(e)(2), § 1.1368–2(a)(5), and § 1.1368–3 Example 2, Example 4, and Example 5 apply to taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998.

[T.D. 8852, 64 FR 71651, Dec. 22, 1999]

§ 1.1374–0 Table of contents.

This section lists the major paragraph headings for §§ 1.1374–1 through 1.1374–10.

§ 1.1374–1 General rules and definitions.

(a) Computation of tax.
(b) Anti-trafficking rules.
(c) Section 1374 attributes.
(d) Recognition period.
(e) Predecessor corporation.

§ 1.1374–2 Net recognized built-in gain.

(a) In general.
(b) Allocation rule.
(c) Recognized built-in gain carryover.
(d) Accounting methods.
(e) Example.

§ 1.1374–3 Net unrealized built-in gain.

(a) In general.
(b) Example.

§ 1.1374–4 Recognized built-in gain or loss.

(a) Sales and exchanges.
(1) In general.
(2) Oil and gas property.
(3) Examples.
(b) Accrual method rule.
(1) Income items.
(2) Deduction items.
(3) Examples.
(c) Section 267(a)(2) and 404(a)(5) deductions.
(1) Section 267(a)(2).
(2) Section 404(a)(5).
(3) Examples.
(d) Section 481(a) adjustments.
(1) In general.
(2) Examples.
(e) Section 995(b)(2) deemed distributions.
(f) Discharge of indebtedness and bad debts.
(g) Completion of contract.
(h) Installment method.
(1) In general.
(2) Limitation on amount subject to tax.
(3) Rollover rule.
(4) Use of losses and section 1374 attributes.
(5) Examples.
(i) Partnership interests.
(1) In general.
(2) Limitations.
(3) Partnership RBIG.
(ii) Partnership RBIL.
(3) Disposition of partnership interest.
(4) RBIG and RBIL limitations.
(i) Sale of partnership interest.
(ii) Amounts of limitations.
(iii) Small interest exception.
(1) In general.
(2) Contributed assets.
(3) Anti-abuse rule.
(6) Section 704(c) gain or loss.
(7) Disposition of distributed partnership asset.
(8) Examples.

§ 1.1374–5 Loss carryforwards.

(a) In general.
(b) Example.

§ 1.1374–6 Credits and credit carryforwards.

(a) In general.
(b) Limitations.
(c) Examples.

§ 1.1374–7 Inventory.