American Institute of CPAs
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October 16, 2014

Mr. Curtis G. Wilson
Associate Chief Counsel (Passthroughs and Special Industries)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Ordinary and Redemption Distributions by S Corporations under Section 1368

Dear Mr. Wilson:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to submit comments with respect to the ordering rule for adjustments to the accumulated adjustments account (AAA) of an S corporation. These comments were developed by the AICPA S Corporations Technical Resource Panel and approved by the AICPA Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 128 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We have identified an ambiguity surrounding the ordering rule in the regulations under section[1] 1368 when ordinary and redemption distributions are made in the same year and an ordinary distribution occurs *after* the redemption distribution. We respectfully request the Internal Revenue Service (IRS) issue additional guidance to provide clarity.[2]

Executive Summary

The AICPA recommends IRS issue a revenue ruling to provide that the AAA balance is adjusted for all ordinary distributions regardless of the timing relative to the redemption, through specific examples or modification of the existing regulations.

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.
[2] The AICPA previously submitted this issue as item 3 on page 34 of the S corporation guidance suggestions in the comments dated May 1, 2014, in response to the annual request by the Internal Revenue Service (IRS) and the Department of the Treasury ("Treasury") for their Priority Guidance Plan.

Background

Treasury Reg. § 1.1368-2(d)(1)(i) provides that "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."[3]

Treasury Reg. § 1.1368-2(d)(1)(ii) provides that if a corporation makes both ordinary and redemption distributions in the same year, the AAA of the corporation is adjusted first for any ordinary distributions and then for any redemption distributions.

Treasury Reg. § 1.1368-2(d)(1)(iii) provides that earnings and profits (E&P) are adjusted under section 312 independently of any adjustments made to the AAA. Thus, the E&P balance of any corporation – whether a C corporation or an S corporation – is adjusted as the result of a redemption distribution.

An S corporation's AAA balance determines how the corporation characterizes distributions to its shareholders with respect to its stock when the corporation also has accumulated E&P. In general, to the extent an S corporation makes distributions out of its AAA balance, such distributions are subject to a simple two-step approach at the shareholder level (*i.e.*, first, a reduction of stock basis and, second, gain from the sale or exchange of the stock). In contrast, to the extent that an S corporation makes distributions in excess of its AAA balance (including where the AAA balance is negative), such distributions are treated as dividends to the shareholders to the extent of the corporation's E&P.

Under the Internal Revenue Code (IRC), the AAA of an S corporation is subject to certain provisions analogous to the provisions governing the E&P of a corporation. Whether the corporation is a C corporation or an S corporation, the determination of its E&P is necessary to determine whether distributions to shareholders are taxed as dividends. As indicated above, the determination of the AAA balance of an S corporation is necessary to determine its ability to make tax-favored distributions to its shareholders when the corporation has E&P.

For most S corporations, the steps necessary to determine the AAA balance and to allocate that balance to ordinary distributions made during the year are reasonably straightforward. However, when an S corporation also redeems some of its stock during the year, this process is fraught with uncertainty. The IRC recognizes that when a corporation redeems some of its stock, it is shrinking all components of its equity base by distributing portions of all these components to the redeeming shareholder.[4] Accordingly, section 1368(e)(1)(B) provides that in the case of a

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[3]The single clarification made by this regulation is that the AAA is adjusted for redemption distributions whether it is positive or negative.

[4] In this letter, any reference to a redemption distribution is one that is described in section 317(b) and is properly treated as a distribution in exchange for the stock pursuant to either section 302(a) or section 303(a). The observations made in this letter do not apply to a redemption distribution that is treated as a section 301 distribution by reason of section 302(d) (*i.e.*, it fails to meet any of the requirements of section 302(b) and is not described in

redemption by an S corporation, the AAA balance of the corporation is adjusted by using the ratio of the shares redeemed to the total number of shares of the corporation's stock "immediately before such redemption."

Likewise, the IRC provides a counterpart for the E&P of a corporation making a redemption distribution. Pursuant to section 312(n)(7), when a corporation redeems its stock, "the part of such distribution which is properly chargeable to E&P shall be an amount which is not in excess of the ratable share of the earnings and profits of such corporation accumulated after February 28, 1913, attributable to the stock so redeemed."

Issues under Existing Guidance

We are concerned with the lack of clarity in applying the ordering rule under the existing regulations when ordinary and redemption distributions are made in the same year and an ordinary distribution occurs after the redemption distribution.

As noted above, although the requirement to make a determination "immediately before such redemption" under section 1368(e)(1)(B) exists, it is not clear whether this clause applies only to the construction of the ratio (*i.e.*, of redeemed shares to total shares), or also applies to the amount of the pre-redemption AAA balance to be adjusted.[5] In addition, although the requirement to make a determination "as of the date of the redemption" under Treas. Reg. § 1.1368-2(d)(1)(i) exists, it is not clear whether this clause applies to the amount of the AAA to be adjusted or the ratio.[6] Finally, Treas. Reg. § 1.1368-2(d)(1)(ii) requires first adjusting the AAA for any ordinary distributions and second for any redemption distributions.

These provisions are readily reconcilable where an S corporation makes all of its ordinary distributions in a taxable year before it redeems any of its stock. For example, the regulations under section 1368 include one example illustrating this rule.[7] The analysis set forth in the example is straightforward because the redemption distribution is made on the last day of the corporation's taxable year after all ordinary distributions were made.

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section 303(a)). Rev. Rul. 95-14, 1995-1 C.B. 169, holds that when an S corporation makes a redemption distribution that is treated as a distribution under section 301 by reason of having failed all of the requirements of sections 302(a) and 303(a), the entire amount of the distribution reduces AAA to the extent provided by section 1368.

[5] The quoted language appears at the end of the sentence and is closer in proximity to the ratio of redeemed shares to total shares than it is to the amount of the AAA balance.

[6] In the regulation, the quoted language appears at the end of the sentence and is preceded by the phrase "the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock."

[7] Treasury Reg. § 1.1368-3, *Example 9*. In this example, an S corporation had two equal shareholders and both E&P and AAA as of the beginning of the taxable year. During the year, the corporation had taxable income and made ordinary distributions that slightly exceeded its income for the year but that did not exceed the sum of beginning AAA and the income for the year. On the last day of its taxable year, the corporation redeemed the shares of one of its shareholders.

The example, however, does not illustrate some of the more typical fact patterns encountered in practice. For example, it is unclear whether the same ordering rules would apply if there were several shareholders whose stock was redeemed at different times during the year and if distributions were made both before and after the redemptions.

To illustrate this ambiguity, we offer the following situation:

S Corp. has two equal individual shareholders, A and B. At the beginning of the year, S has a $7,000 AAA balance. During the year, S has $8,000 of taxable income and makes two distributions for a total of $12,000. In the middle of the year, S redeems all of the stock of B. We will consider two different approaches to the application of section 1368(e)(1)(B).

Based on the facts above and depending on one's own interpretation, two different results are attainable.

Interpretation #1

Under the first interpretation, the timing of the redemption distribution is not taken into account. Thus, the ending AAA balance prior to the redemption distribution is $3,000 (beginning balance of $7,000, plus income of $8,000, reduced by distributions of $12,000). The tentative ending AAA balance is then reduced by 50%, or $1,500. As a result, S would have an AAA balance of $1,500 at the end of the year after considering the redemption distribution.

Therefore, S computes the ending AAA balance as follows:

The beginning AAA balance	$7,000
Current year income	$8,000
Current year distribution	($12,000)
The tentative ending AAA balance before the redemption	$3,000
Less: ratable share of the redemption – shareholder B	($1,500)
The adjusted ending AAA balance	$1,500

Interpretation #2

Under the second interpretation, the timing of the redemption distribution is taken into account, recognizing that, as an economic matter, the amount of the distribution reflects the parties' views of the corporation's balance sheet at that time. However, pursuant to the requirement under the regulations that ordinary distributions take priority over redemption distributions, the current-year effects of the taxable income and distributions would produce a net reduction of $4,000 ($8,000 of taxable income less $12,000 of distribution) in AAA. If one were to prorate that net change to the date of the redemption, the pre-redemption AAA balance is $5,000 (beginning balance of $7,000 reduced by 50% of the $4,000 net reduction for the year, or $2,000). The redemption would thus reduce the AAA by $2,500, and the AAA balance at the end of the year is

$500 (beginning balance of $7,000, plus income of $8,000, reduced by ordinary distributions of $12,000, and further reduced for redemption distributions in the amount of $2,500).

Therefore, S computes the ending AAA balance as follows:

The beginning AAA balance	$7,000
Current year income	$8,000
Current year distribution	($12,000)
The ending AAA balance before the redemption	$3,000
Less: ratable share of the redemption– shareholder B	($2,500)
The adjusted ending AAA balance	$500

As illustrated above, the lack of clarity existing in this rule creates confusion and misunderstanding by taxpayers. Thus, additional guidance clarifying the ordering rule would allow taxpayers to correctly apply the rule and avoid potential controversy.

Conclusion

In our view, adjusting the AAA balance for all ordinary distributions regardless of the timing relative to the redemption provides a more reasonable outcome in most circumstances. Since a complete redemption is a sale or exchange transaction, the presence of AAA is irrelevant for purposes of determining the shareholder's gain or loss on the redemption. Allocating more AAA to redemptions by ignoring post redemption distributions does not benefit the redeemed shareholder, while it provides a smaller AAA for later distributions to the recipient shareholders. Therefore, the AICPA recommends the IRS issue a revenue ruling to provide such guidance through specific examples or modification of the existing regulations.

We have surveyed the principal treatises and other authorities on S corporation taxation and find that the authors do not share a consistent view on adjusting the AAA balance of an S corporation when stock is redeemed other than at the end of the taxable year.[8] Therefore, additional guidance would eliminate the current ambiguity in the regulations for many S corporations and tax professionals. Upon request, we can provide our analysis of the various examples set forth in these secondary authorities for your further consideration of this issue.

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We welcome the opportunity to answer any questions that you may have or to meet with representatives of your office to work through other examples. I can be reached at (304) 522-

[8] *See, e.g.*, S. Starr and H. Sobol, Tax Mgt. Portfolio 731-2nd: *S Corporations: Operations*; R. Jamison, *S Corporation Taxation Guide* ¶ 1503.03, Example 15-30; PPC's *Tax Planning for S Corporations*, Section 1405, Examples 14-8 and 14-9; J. Eustice and J. Kuntz, *Federal Income Taxation of S Corporations* ¶ 8.04[7][e]; and Christian and Grant, *Subchapter S Taxation* ¶ 28.14[5], Examples 28-11 and 28-12.

2553, or jporter@portercpa.com; or you may contact Christopher Hesse, Chair of the S Corporation Taxation Technical Resource Panel, at (612) 397-3071, or chris.hesse@claconnect.com; or Jason Cha, AICPA Technical Manager, at (202) 434-9231, or jcha@aicpa.org.

Sincerely,

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Chair, Tax Executive Committee