



S Corporations and the AAA Account
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S Corporations and AAA

The IRS issued some guidance regarding handling an account that generates a bit of confusion with regard to S corporations—the accumulated adjustments account we find defined in IRC §1368(e)(1) and its relevance and impact on S corporations and their shareholders. What the IRS addressed was the issue of what happens for AAA purposes if the S corporation pays for key man life insurance, both in the case when the premiums are paid and when proceeds from the policy are received. The IRS issued Revenue Ruling 2008-42 to explain the impact in that case.

What we'll review includes the overall importance of AAA, its relationship (or lack thereof) to shareholder basis in the shareholders' shares, and how we go about computing it (including the notice described above).

AAA's Relevance

The actual definition of the accumulated adjustments account is found in IRC §1368, which deals with distributions from an S corporation. That section starts out with the following provision in §1368(a):

(a) General rule

A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

IRC §301(c) generally deals with distributions from a corporation in the ordinary course of business. Such distributions will be considered taxable dividends under §316 to the extent of the corporation's earnings and profits, either since inception (presuming inception is after February 28, 1913, generally the case for my clients) or out of current year earnings and profits. If both of those items are exhausted by the distribution (or were zero before the distribution), 301(c) provides that the distribution will apply against the shareholder's basis in the stock [§301(c)(2)] and, when basis is exhausted, be treated as gain from the sale or exchange of property (subject to another pre-1913 appreciation rule we'll generally not worry about at this date) [§301(c)(3)].

No Earnings and Profits

S corporation distributions fall into two categories. For an S corporation without earnings and profits, the rule is very simple and no reference is made to the accumulated adjustments account. This case is covered by §1368(b) which provides:

(b) S corporation having no earnings and profits

In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits--

(1) Amount applied against basis

The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

(2) Amount in excess of basis

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.

As you may note, the application becomes very similar to what we see for C corporation distributions where there are no earnings and profits (absent the pre-1913 provisions).

We first recover stock basis (note that debt basis doesn't enter into this calculation) and then have a gain from the sale or exchange of the stock.

An S corporation shareholder's basis modifications over time are governed by §1367, with §1367(a)(1) providing for items that increase a shareholders' basis:

(1) Increases in basis

The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

- (A) the items of income described in subparagraph (A) of section 1366(a)(1),
- (B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and
- (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

Decreases in basis are covered by §1367(a)(2), which provides:

(2) Decreases in basis

The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

- (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
- (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
- (C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),
- (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and
- (E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

As always, basis cannot be pushed below zero—if the math would cause that to happen, we end up with either losses held back due to lack of basis or taxable gain events (when distributions exceed basis).

Regulation §1.1367-1(f) provides an ordering rule on how to apply these adjustments, an ordering that used to be different for tax years beginning prior to August 18, 1998 (so if you last looked into this a decade ago, your knowledge would be a bit dated):

- (f) Ordering rules for taxable years beginning on or after August 18, 1998.
- For any taxable year of a corporation beginning on or after August 18, 1998, except as provided in paragraph (g) of this section, the adjustments required by section 1367(a) are made in the following order --
- (1) Any increase in basis attributable to the income items described in section 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in section 1367(a)(1)(C);
 - (2) Any decrease in basis attributable to a distribution by the corporation described in section 1367(a)(2)(A);
 - (3) Any decrease in basis attributable to noncapital, nondeductible expenses described in section 1367(a)(2)(D), and the oil and gas depletion deduction described in section 1367 (a)(2)(E);
 - (4) Any decrease in basis attributable to items of loss or deduction described in section 1367(a)(2)(B) and (C).

Note that a shareholder gets credit for increases first, then we take the distributions and only after those come out does basis get reduced by the items that decrease basis. What that means is that, effectively, if the shareholder has basis at the beginning of the year, the shareholder won't exhaust basis by taking a distribution during the year up to that amount of basis. Prior to the effective date of this new ordering rule (generally for 1999 and later calendar years) that wasn't the case, as distributions came out last under the old rule.

For today's podcast what is important to note is that, at this point, we've had no mention at all of the accumulated adjustments account—and that's because, as will become clear, AAA's purpose is let us know when we distributing out earnings and profits from the corporation. A corporation with no E&P does not have an issue with AAA. A corporation that has always been an S corporation since inception, and which came into being after the 1982 S Corporation Act would not have such earnings and profits unless it somehow picked up the “taint” of a C corporation (perhaps via merging with it).

Earnings and Profits and AAA

AAA finally appears in the Internal Revenue Code when we get to §1368(c), which provides:

[Redacted text]

(c) S corporation having earnings and profits

In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits--

(1) Accumulated adjustments account

That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

(2) Dividend

That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

(3) Treatment of remainder

Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (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 this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes.

Note that §1368(b), which ignores the AAA account, governs distributions generally except for the band covered by §1368(c)(2) which handles the treatment of the earnings and profits.

As well, note this is a *corporate* determination and not one done at the shareholder level. Contrast that with the basis provisions of §1367, which is a *shareholder* determination. That difference is a key matter to understand to consider the relevance of AAA.

The accumulated adjustments account is defined in §1368(e)(1)(A) in general, which provides the following:

(A) In general

Except as otherwise provided in this subparagraph, the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in section 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.

It is important to remember that while AAA is defined by reference to the basis adjustment items in §1367, it excludes nontaxable income and nondeductible expenses, and it is a corporate calculation. What that means is that there is no direct link between total shareholder basis and the accumulated adjustments account—and any attempt to reconcile the concepts is going to face a number of special adjustments, especially for any case of anything more than an extremely simple S corporation.

As well, as we'll note below, the fact that nontaxable income doesn't add to AAA (though it does increase basis) means that such income (net of expenses related to tax exempt income) is “trapped” below any earnings and profits that might exist for purposes of distributions. This particular issue was the matter the IRS ruled upon in the Revenue Ruling 2008-42 issued this week.

One special adjustment is defined in §1368(e)(1)(B) for the cases of redemptions:

(B) Amount of adjustment in the case of redemptions

In the case of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

Essentially, AAA is reduced prorata whenever you have a transaction that qualifies as a redemption under either §§302(a) or 303(a).

It's also important to note that the method of handling current year items is also different from the basis impact for current year activity. The AAA method is found at IRC §1368(e)(C)

(C) Net loss for year disregarded

(i) In general

In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.

(ii) Net negative adjustment

For purposes of clause (i), the term "net negative adjustment" means, with respect to any taxable year, the excess (if any) of--

(I) the reductions in the account for the taxable year (other than for distributions), over

(II) the increases in such account for such taxable year.

Unlike the basis calculation, in this case we don't get all of the positives and none of the negative adjustments—rather, we simply can't reduce below the starting AAA number before computing our distribution.

Finally, the corporation (again, this is a corporate rather than shareholder matter) with the consent of all “affected shareholders” may elect to treat distributions as coming first from earnings & profits:

(3) Election to distribute earnings first

(A) In general

An S corporation may, with the consent of all of its affected shareholders, elect to have paragraph (1) of subsection (c) not apply to all distributions made during the taxable year for which the election is made.

(B) Affected shareholder

For purposes of subparagraph (A), the term "affected shareholder" means any shareholder to whom a distribution is made by the S corporation during the taxable year.

Regulation §1.1368-1(f)(3) even allows us to simply act as if a distribution of the earnings and profits was made even if nothing is actually distributed:

(3) Election to make a deemed dividend.

An S corporation may elect under this paragraph (f)(3) to distribute all or part of its subchapter C earnings and profits through a deemed dividend. If an S corporation makes the election provided in this paragraph (f)(3), the S corporation will be considered to have made the election provided in paragraph (f)(2) of this section (relating to the election to distribute earnings and profits first). The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. The amount of the deemed dividend is considered, for all purposes of the Internal Revenue Code, as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

In this case, you have a taxable distribution to the shareholders, followed by a capital contribution.

Why would you do this? A key reason is the tax found at §1375 on excess passive income and (more ominously) the loss of S corporation status for a corporation that has

excess passive income for three straight years under §1362(d)(3) apply only to S corporations with accumulated earnings and profits at the end of a tax year. An S corporation that may, for instance, have left in it only highly appreciated assets after selling off or ceasing its business operations might want to continue in S status. A distribution of the assets would trigger gain (but not loss) recognition under §311(b), but it's very possible those assets would start to generate passive income.

As well, it's possible the assets in question would also be subject to the built in gains tax under §1374 if gain were triggered at this time. In that case, the most prudent might be to treat distributions as coming out of earnings and profits or even accepting a deemed dividend just to clean up the S corporation. However, remember that while getting rid of the earnings and profits will remove §1375 excess passive income tax exposure, it does not impact the built-in gains tax exposure under §1374.

Life Insurance

Now we can look at the IRS ruling from this week. In this ruling the IRS considered the proper treatment for key person life insurance proceeds and premiums. Specifically, the IRS considered the following two questions under Revenue Procedure 2008-42:

- (1) Do premiums paid by an S corporation on an employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, reduce the S corporation's accumulated adjustments account (AAA)?
- (2) Do the benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under § 101(j)(2) increase an S corporation's AAA?

The IRS uses the following presumed facts in making this ruling:

X is a corporation that has a valid S election in effect. X purchases an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee is a highly compensated employee of X. X pays all of the premiums for the policy. X is a beneficiary of the policy. At the end of the taxable year, X has subchapter C accumulated earnings and profits (E&P).

The IRS doesn't completely explain the logic used in arriving at their conclusion, but it appears (and makes sense) that the IRS decided that the proceeds from the policy represents income exempt from taxation and, similarly, the premiums paid represent expenses related to such tax exempt income. As such, the IRS arrives at the following conclusions:

- (1) Premiums paid by an S corporation on an employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, do not reduce the S corporation's AAA.
- (2) The benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under § 101(j)(2) do not increase the S corporation's AAA.

Impact for a Redemption Based Buy/Sell

Recall that we are given special rules under §1368(e)(1)(B) for a redemption of shares and its impact on the AAA account. We can consider that ruling in addition to what we now know to look at an example of a situation when we have a buy/sell arrangement where the corporation is obligated to purchase the shares of a deceased shareholder, and has obtained life insurance to pay for that obligation.

Let us presume that in year 1 of the S election the corporation had net earnings before paying the insurance premiums of \$100, and paid premiums of \$5, and had \$100 of accumulated earnings and profits from its previous C corporation years and, conveniently, began the year with \$100 cash as its only asset. As well, presume we have two equal shareholders and the buy/sell agreement provides the corporation will redeem a shareholder's interest on death and the corporation had \$100 of insurance on each shareholder to fund that obligation.

At the end of year one, the accumulated adjustments account, earnings and profits and other adjustments account (the “catch all” for items that don't hit AAA and don't impact earnings and profits) are as follows:

Year 1	Accumulated Adjustments Account	Accumulated Earnings & Profits	Other Adjustments Account
Beginning Balance	\$ -	\$ 100	\$ -
Income	100	0	0
Premiums	0	0	-5
Ending Balance	\$ 100	\$ 100	\$ -5

Presuming that our \$100 of income was cash income (and we'll make that simplifying assumption), we should end the year with \$195 as our asset and book equity of \$195.

In year 2, one shareholder dies before any premium is paid (and the second shareholder decides not to renew his policy). The corporation receives the proceeds of \$100 on the policy and its net income otherwise for the year is \$100 again.

Year 2	Accumulated Adjustments Account	Accumulated Earnings & Profits	Other Adjustments Account
Beginning Balance	\$ 100	\$ 100	\$ -5
Income	100	0	0
Insurance proceeds	0	0	100
Redemption ½ shares	-50	-50	0
Ending Balance	\$ 150	\$ 50	\$ 95

The corporation has \$295 in cash (\$195 starting + \$100 income + \$100 proceeds - \$100 redemption payment).

Note that once the redemption takes place, we now have income “trapped” below the earnings and profits of the corporation for distribution purposes, since even though the insurance proceeds went to pay off the deceased shareholder's estate, effectively the net proceeds remained in the other adjustments account, while the AAA and earnings and profits were adjusted.