Foster Garvey

Larry's Tax Law

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part IX - Taking the Mystery Out of the S Corporation Distribution Rules

07.17.24

Unlike the rules contained in Subchapter K surrounding partnership distributions, which tend to be somewhat complex, the distribution rules contained in Subchapter S are fairly straightforward. Nevertheless, from time to time, taxpayers and tax advisers appear to experience difficulty navigating through the applicable S corporation distribution rules. This Part IX of my multi-part blog series on S corporations is designed to take some of the mystery out of the S corporation distribution rules. The following is a brief overview of the S corporation distribution rules.

Background

The purpose of pass-thru taxation under Subchapter S is to avoid the imposition of an entity-level tax. Shareholders of S corporations are taxed on their proportionate share of the corporation's income, regardless of whether it is actually received; therefore, distributions from S corporation income should not be taxed again, otherwise there would be a second tax on such income, undercutting the purpose of pass-thru taxation. IRC §1368 allows for shareholder distributions in a manner that avoids double-taxation of S corporation income, but it still imposes an entity-level tax on the earnings and profits ("E&P") remaining from any prior operations as a C corporation. Much of the complexity within the Subchapter S distribution rules is due to these latter rules, which are designed to prevent C corporations from avoiding double-taxation on C corporation earnings by simply electing S corporation status.

At a fundamental level, distributions from S corporations must be analyzed in one of two categories: S corporations without E&P and S corporations with E&P.

© 2026 Foster Garvey PC. All Rights Reserved.

S Corporations Without E&P

Under IRC §1368(b)(1), distributions to a shareholder by an S corporation that does not have E&P, as described in IRC §312, are tax free to the extent of the shareholder's adjusted basis in the S corporation stock. If the distribution exceeds the shareholder's basis, then under IRC §1368(b)(2) the excess is treated as a gain from the sale or exchange of an asset (a capital gain, since stock is a capital asset). The shareholder's basis is reduced by the amount of distributions not included in income. IRC §1367(a)(2)(A). The rules for S corporations without E&P are simple.

S Corporations with E&P

When an S corporation has E&P, either from prior operations as a C corporation or due to the acquisition of a C corporation through merger or otherwise, the distribution rules become more complex.

If an S corporation has E&P, some mechanism is needed to separate its operating results as an S corporation from its operating results as a C corporation in order to properly determine the tax consequences of any distribution. The Accumulated Adjustments Account ("AAA") was statutorily created to be that mechanism, and it can be understood as a cumulative total of the undistributed earnings of the corporation that have been taxed to shareholders while it has been operating as an S corporation.

The AAA is a corporate-level account. Accordingly, it is not apportioned among shareholders. Treas. Reg. §1.1368-2(a). The beginning balance of the AAA is zero on the first day of the first taxable year for which a corporation is an S corporation. Treas. Reg. §1.1368-2(a)(1)(2).

The AAA is adjusted in a similar manner to the basis adjustments in IRC §1367, except:

- There are no adjustments for tax-exempt income;
- There are no adjustments for federal taxes attributable to operations as a C corporation; and
- The AAA cannot be decreased below zero. See Reg. §1.1368-2(a); IRC §1368(e)(1)(A).

Adjustments to an S corporation's E&P occur independently of any adjustment to its AAA account. Treas. Reg. §1.1368-2(d)(1)(iii).

Under IRC §1368(c)(1), distributions for amounts not exceeding the AAA are treated the same as distributions by S corporations without E&P. First, there is a tax-free recovery of basis, to the extent of the shareholder's adjusted stock basis, then the amount in excess of the shareholder's basis is treated as a gain from the sale or exchange of stock. IRC §1368(b).

Distributions in excess of the AAA are first treated as a dividend to the extent of E&P, then as a tax-free recovery of the remaining basis, then as a gain from the sale or exchange of stock. IRC §1368(c)(2)-(3). This is similar to the treatment of C corporation dividends under IRC §301(c).

© 2026 Foster Garvey PC. All Rights Reserved.

If the amount of annual distributions exceeds the AAA, the AAA is proportionately allocated based on the amount of each distribution during the tax year. IRC §1368(c); Treas. Reg. §1.1368-2(b)(2).

If all affected shareholders of an S corporation consent, IRC §1368(e)(3) allows the corporation to elect to distribute E&P first by treating distributions as if they were dividends. The applicable rules in Treas. Reg. §1.1368-1(f) allow S corporations to elect to treat distributions first as dividends to the extent of E&P, then any excess is treated as a tax-free recovery of basis to the extent of AAA, and any further excess is treated as a gain from the sale or exchange of stock. Such elections are irrevocable and are effective only during the tax year when made. Treas. Reg. §1.1368-1(f)(5)(iv).

The IRC §1368(e)(3) election allows for an S corporation with E&P to quickly distribute its entire E&P. The benefit of this election is that after E&P is eliminated, the S corporation can operate without having to consider its AAA when making distributions (unless it subsequently acquires E&P). The downside to this election is that the S corporation shareholders are taxed on the distributions as dividends, which they would otherwise receive as a tax-free recovery of their basis.

PRACTICE ALERT: An IRC §1368(e)(3) election can come in handy if an S corporation is facing the passive investment income tax under IRC §1375 or termination of its S election under IRC §1362(d)(3). Using the IRC §1368(e)(3) election to bail out E&P could save the day.

Other Rules

When an S corporation distribution is treated as a redemption under IRC §302 or IRC §303, the AAA is adjusted in an amount equal to the ratable share of the AAA attributable to the redeemed stock as of the redemption date. Treas. Reg. §1.1368-2(d)(1)(i). If an S corporation makes both ordinary distributions and IRC §302/§303 redemption distributions in the same year, the AAA is first adjusted for the ordinary distributions before it is adjusted for the redemption distributions. Id. at (2)(d)(1)(ii).

PRACTICE ALERT: Various adjustments to the AAA may be required when an S corporation merges with another S corporation or transfers some of its assets to another corporation. See Treas. Reg. §1.1368-2(d)(2)-(3).

When applied to yearly distributions, the AAA is determined without regard to any net negative adjustment for the taxable year, defined as the excess of reductions to the AAA over increases to the AAA. IRC

© 2026 Foster Garvey PC. All Rights Reserved.

§1368(e)(1)(C).

Although the pass-thru rules of S corporations are similar to the rules applying to partnerships under Subchapter K, IRC §1368 follows the general rules for corporate distributions and does not distinguish between distributions of cash and property as is done with partnerships. Under IRC §301, any distribution of property is to be based on the fair market value ("FMV") of the property and S corporation shareholders receive a basis in the distributed property equal to its FMV. Under IRC §1367(a)(2)(A) and IRC §1368, each shareholder's basis in the S corporation stock is reduced by the FMV of the property received in the distribution.

Conclusion

The rules surrounding distributions in the S corporation world are much less complex than the analogous rules contained in Subchapter K for partnerships and their partners. I hope this summary of the S corporation distribution rules takes away some of the mystery and is helpful to tax advisers and their clients. My multi-part blog series on "A Journey Through Subchapter S" will continue. Stay tuned!

Posted in Internal Revenue Code, Tax Laws, Tax Planning

Tagged as A Journey Through Subchapter S, Accumulated Adjustments Account (AAA), C corporation, distribution rules, earnings and profits, S corporation

Authored by

Larry J. Brant

Principal|Portland

503.553.3114 larry.brant@foster.com

© 2026 Foster Garvey PC. All Rights Reserved.