[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-131071-18]

RIN 1545-BP20

Eligible Terminated S Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This notice of proposed rulemaking provides rules regarding the definition of an eligible terminated S corporation (ETSC). In addition, these proposed regulations provide rules relating to distributions of money by an ETSC after the post-termination transition period (PTTP). Finally, these proposed regulations revise current regulations to extend the treatment of distributions of money during the PTTP to all shareholders of the corporation and to update and clarify the allocation of current earnings and profits to distributions of money and other property. These proposed regulations would affect certain C corporations and the shareholders of such corporations.

DATES: Comments and requests for a public hearing must be received by **[INSERT DATE 45 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Submit electronic submissions via the Federal Rulemaking Portal at https://www.regulations.gov (indicate IRS and REG-131071-18) by following the online instructions for submitting comments. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-131071-18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-131071-18), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC, 20224.

FOR FURTHER INFORMATION CONTACT: Concerning proposed regulations §§ 1.481-5, 1.481-6, 1.1377-2, and 1.1377-3, Margaret Burow or Michael Gould at (202) 317-5279; concerning proposed regulations §§1.1371-1 and 1.1371-2, Aglaia Ovtchinnikova at (202) 317-6975, Kevin M. Jacobs at (202) 317-5332, or Margaret Burow or Michael Gould at (202) 317-5279; concerning proposed regulation §1.316-2, Aglaia Ovtchinnikova at (202) 317-6975 or Kevin M. Jacobs at (202) 317-5332; concerning submissions and the hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. Overview

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 481 and 1377 of the Internal Revenue Code (Code) and proposed regulations under section 1371 of the Code. Section 13543(a) and (b) of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2155 (2017) (TCJA), amended the Code to add subsection (d) to section 481, and subsection (f) to section 1371. Both section 481(d) and section 1371(f) are effective as of December 22, 2017.

II. Summary of PTTP and ETSC Period

Generally, a distribution by a C corporation to its shareholders with respect to their stock ownership is treated as a taxable dividend to the extent of the corporation's earnings and profits. See sections 301(c) and 316(a). However, following the termination of an S corporation's election made under section 1362 (S election), section 1371(e) allows shareholders of the resulting C corporation to benefit from the corporation's former status as an S corporation with respect to distributions of money during the corporation's PTTP, which is generally the one-year period after the S election terminates. Specifically, during the PTTP, a distribution of money by the C corporation is characterized as a distribution from the corporation's accumulated adjustments account (AAA), as defined in §1.1368-2(a)(1). The receipt of such a distribution is tax-free to the extent of the recipient's basis in its stock with respect to which it received the distribution, and is taxed as gain from the sale of property to the extent the distribution exceeds the recipient's basis in that stock. If the corporation exhausts its AAA during the PTTP, then subsequent distributions are subject to treatment under section 301. Without section 1371(e), shareholders of the former S corporation would be precluded from receiving distributions allocable to AAA.

Section 1371(f) extends the period during which the shareholders of a C corporation can benefit from AAA generated during such corporation's former status as an S corporation (ETSC period) by allowing a C corporation's distribution of money to which section 301 would otherwise apply (qualified distribution) to be sourced, in whole or in part, from AAA. Specifically, section 1371(f) provides that (i) the distributing ETSC's AAA is allocated to a qualified distribution, and (ii) the qualified distribution is chargeable to accumulated earnings and profits (AE&P), in the same ratio as the amount of such AAA bears to the amount of such AE&P (clauses (i) and (ii), collectively, ETSC proration). In enacting section 1371(f), Congress determined that “it is important to provide rules to ease the transition from S corporation to C corporation for the affected taxpayers” because, based on TCJA revisions to the Code, “taxpayers that previously elected to be taxed as S corporations may prefer instead to be taxed as C corporations.” H. Rept. 115-409, at 245 115th Cong. 1st Sess., (Nov. 14, 2017) (House Report).

Explanation of Provisions

I. Requirements to Qualify for Section 1371(f) Treatment

If a C corporation satisfies the ETSC qualification requirements, section 1371(f) provides special treatment for qualified distributions made by an ETSC during the ETSC period, which begins with the expiration of the PTTP and ends when the corporation exhausts its AAA.

A. ETSC Qualification Requirements

1. In General

In order for section 1371(f) to apply, the distributing corporation must be an ETSC. In conjunction with the enactment of section 1371(f), Congress enacted section 481(d), which includes the definition of an ETSC. Specifically, a C corporation qualifies as an ETSC if the following three requirements are satisfied. First, the corporation was an S corporation on December 21, 2017. Second, during the two-year period beginning on December 22, 2017, the S corporation revoked its S election (revocation requirement). Third, the owners of the stock of the corporation are the same owners (and in identical proportions) on December 22, 2017, and the date that the corporation made a revocation of its S election (shareholder identity requirement).

2. Revocation Requirement

In contrast to the PTTP, which applies regardless of how an S corporation's election terminates, section 1371(f) applies only if the S election is revoked (section 1362(d)(1)), which, under section 1362(d)(1)(B), requires the consent of shareholders holding more than 50 percent of the corporation's shares in the aggregate. Section 1362(d)(1) and its underlying regulations provide the sole means for an S corporation to revoke its S election. Pursuant to §1.1362-6(a)(3), a valid revocation requires an S corporation to submit a written statement that the corporation revokes its S election. That revocation statement must set forth the number of shares of stock (including non-voting stock) issued and outstanding at the time of the revocation and must be accompanied by a separate written statement of shareholder consent. See §1.1362-6(a)(3)(i), (b).

Generally, a revocation made on or before the 15th day of the third month of a taxable year is effective on the first day of that year, and an election made after that date is effective on the first day of the following taxable year. See section 1362(d)(1)(C) and §1.1362-2(a)(2)(i). However, if the revocation specifies a date for revocation that is on or after the day on which the revocation is made, the revocation becomes effective on that specified date. See section 1362(d)(1)(D) and §1.1362-2(a)(2)(ii). Therefore, under the proposed regulations, the revocation requirement would be satisfied if the revocation of an S election is validly made during the two-year period beginning on

December 22, 2017, even if the effective date for the revocation occurs after the conclusion of that two-period.

3. Shareholder Identity Requirement

For a former S corporation to qualify as an ETSC, the owners of its stock must be the same owners (and in identical proportions) on the following two dates: (1) December 22, 2017, and (2) the date on which the S corporation made a revocation of its S election. However, certain events should not affect the shareholder identity requirement because such events would not change in substance the identity of the subject shareholder. Specifically, these proposed regulations identify five categories of stock transfers that do not result in an ownership change for purposes of section 481(d)(2)(B): (1) transfers of stock between a shareholder and that shareholder's trust treated as wholly owned by that shareholder under subpart E of subchapter J of chapter 1; (2) transfers of stock between a shareholder and an entity owned by the shareholder that is disregarded as separate from its owner under §301.7701-2(c)(2)(i) of the Procedure and Administration Regulations; (3) an election by a shareholder trust to be treated as part of a decedent's estate under section 645 or the termination of an election under that section; (4) a change in the status of a shareholder trust from one type of eligible S corporation shareholder trust described in section 1361(c)(2)(A) to another type of eligible S corporation shareholder trust; and (5) a transaction that includes more than one of the events described in (1) through (4).

While specifying transaction categories provides certainty to taxpayers, the Treasury Department and the IRS request comments regarding whether a principlebased rule would be more effective, as well as suggestions as to the rule's proposed operative language.

B. Requirement for Corporation to Have AAA

Section 1371(f) provides that AAA is allocated to a qualified distribution based on the ratio of AAA to AE&P. Thus, if an ETSC has no AAA, section 1371(f) has no application. In addition, as evidenced by the fact that Congress enacted section 1371(f) to ease the transition from S corporation status to C corporation status, the ETSC period is intended to be transitory in nature. Consequently, the Treasury Department and the IRS have determined that such a transition would naturally conclude once the C corporation's AAA balance reaches zero. In other words, an ETSC has an ETSC period only if the ETSC has a AAA balance greater than zero at the end of its PTTP, and the ETSC period ends immediately after the qualified distribution that causes the C corporation's AAA balance to reach zero.

C. Conclusion of PTTP; Multiple PTTPs

Section 1377(b)(1) provides that a PTTP occurs in the following three circumstances. First, a PTTP may occur during the period starting on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of (i) the day that is one year later or (ii) the due date for filing the return for such last year as an S corporation (including extensions). Second, a PTTP may occur during the 120-day period beginning on the date of any determination pursuant to an audit of a taxpayer that follows the termination of the corporation's election and adjusts a subchapter S item that arose during the S period (intervening audit PTTP). Third, a PTTP may occur during the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

Section 1371(f) applies to certain distributions "after the post-termination transition period." The Treasury Department and the IRS received a comment regarding intervening audit PTTPs and, accordingly, considered whether the ETSC period continues following an intervening audit PTTP that occurs during the ETSC period. Based on the overall purpose of these proposed regulations to ease the transition from S corporation status to C corporation status, the Treasury Department and the IRS have determined that the ETSC period should resume immediately following the conclusion of an intervening audit PTTP, if the ETSC continues to have a AAA balance greater than zero.

II. Mechanics of Section 1371(f)

A. Shareholders Eligible to Receive Qualified Distributions

By its terms, section 1371(f) does not require the recipients of qualified distributions to have been shareholders of the S corporation at the time of revocation, and no part of the House Report indicates a Congressional intent to impose such a limitation (no-newcomer rule) on such distributions. The Treasury Department and the IRS received a comment requesting guidance to clarify which shareholders are eligible to receive distributions from a corporation's AAA during the ETSC period. A no-newcomer rule would be inconsistent with Congressional intent to ease the transition of former S corporations to full C corporation status because such a no-newcomer rule would impede an ETSC's ability to exhaust its AAA. A no-newcomer rule also would impose an administrative burden on ETSCs and create complexity by requiring ETSCs to report distributions disparately depending on the recipient. See House Report at 245. Additionally, a rule allowing newcomers would be more consistent with treating the AAA as a corporate-level account.

In the absence of a no-newcomer rule, shareholders that were shareholders on the date that the corporation's S election revocation was made would continue to receive qualified distributions, whether or not there are new shareholders or changes in the historical S corporation shareholders' proportionate interests on or after such date. Moreover, new shareholders, whether eligible S corporation shareholders or not, that acquire stock of an ETSC on or after the date that the revocation was made may receive qualified distributions, all or a portion of which may be sourced from AAA. Such outcomes would best implement the plain language of section 1371(f) and the policy objective of easing the transition of affected taxpayers from S corporation status to C corporation status. Accordingly, these proposed regulations do not impose a no-newcomer rule with respect to the ETSC period.

B. Implementation of ETSC Proration

As discussed in Part II of the Background, section 1371(f) provides that (i) the distributing ETSC's AAA is allocated to a qualified distribution, and (ii) such qualified distribution is chargeable to the ETSC's AE&P, based on the ETSC proration. These proposed regulations would implement this provision in a manner designed to facilitate the ETSC's prompt distribution of AAA and full transition to C corporation status, and thereby "ease the transition from S corporation to C corporation for the affected taxpayers." House Report at 245. Grounded in that policy, these proposed regulations (i) specify the time at which amounts of AAA and AE&P are determined for purposes of the ETSC proration, (ii) clarify the AAA and AE&P ratios used to implement the ETSC proration, and (iii) describe in detail the method of characterizing qualified distributions.

1. When to Determine the Amounts of AAA and AE&P for Purposes of ETSC Proration

The Treasury Department and the IRS considered when to measure the AAA and AE&P for purposes of the ETSC proration. The Treasury Department and the IRS considered a "Snapshot Approach," under which the amounts of AAA and AE&P would be determined on a specified date (historical AAA and historical AE&P, respectively), resulting in the same ETSC proration being applied to all qualified distributions. The Treasury Department and the IRS also considered a "Dynamic Approach," under which the amounts of AAA and AE&P would be recalculated before each qualified distribution.

These proposed regulations adopt the Snapshot Approach, with a special additional rule to facilitate distributions of AAA when the ETSC's historical AE&P has been exhausted and the ETSC still has AAA. See Part II.C.1 of this Explanation of Provisions. The Snapshot Approach would provide affected taxpayers with an easier transition to full subchapter C status. Under this approach, ETSCs generally would be required to calculate AAA and AE&P for purposes of the ETSC proration only once, as opposed to numerous times under the Dynamic Approach. Also, the Dynamic Approach could significantly delay shareholder access to the ETSC's AAA. While the amount of an ETSC's AAA could never increase during the ETSC period (other than by reason of a redetermination of AAA), such ETSC's AE&P would increase as the amount of any undistributed current earnings and profits is carried forward to the next taxable year.

For the Snapshot Approach, the Treasury Department and the IRS considered two possible determination dates: (1) the beginning of the day for which the revocation of an election under section 1362(a) is effective pursuant to section 1362(d)(1), and (2) immediately after the end of the PTTP. Under these proposed regulations, the determination date would be the beginning of the day on which the revocation of an election under section 1362(a) is effective. Determining the amount of AAA on this date, which can be readily achieved by referencing the ETSC's final Form 1120S, would avoid the complexity of determining the proper amount of historical AAA in the event of an intervening audit PTTP for distributions made after the initial PTTP and before the intervening audit PTTP. In addition, the ETSC and its shareholders would have greater certainty during the PTTP as to the tax characterization of distributions to be made during the ETSC period under this approach. Reference to this determination date also would facilitate the receipt of AAA by the ETSC's shareholders as quickly as possible by maximizing the amount of AAA factored into the ETSC proration. Since S corporations with no subchapter C history will have no AE&P as of the beginning of the effective date of the revocation, using this determination date also would minimize the AE&P that is factored into the ETSC proration, as compared to determining AE&P immediately after the end of the PTTP. As a result, the use of this determination date would facilitate the corporation's transition to full subchapter C status.

The Treasury Department and the IRS request comments regarding the proposed regulations' adoption of the Snapshot Approach, in particular with respect to the timing of determining an ETSC's historical AAA and historical AE&P amounts, and whether such amounts should be adjusted by certain transactions, as well as any potential alternative approaches for computing the ETSC proration. For example, the Treasury Department and the IRS acknowledge that not all ETSCs may favor the approach with respect to timing that these proposed regulations adopt. In particular, an ETSC that makes no distributions of AAA and operates at a loss during its PTTP may prefer to determine its AAA and AE&P ratios immediately after the end of the PTTP. Determining the ratios on this later date would result in a lower historical AE&P amount, and therefore the percentage of the qualified distribution that could be characterized as a distribution of AAA would be greater when compared to the approach adopted by these proposed regulations.

2. ETSC Proration Based on Ratios Composed of Historical AAA and Historical AE&P

Section 1371(f) provides that AAA is allocated to a qualified distribution, and such distribution is chargeable to AE&P, in the same ratio as the amount of such AAA bears to the amount of such AE&P. Therefore, section 1371(f) requires an allocation of two distinct pools of an ETSC's historical earnings with respect to a qualified distribution (that is, AAA and AE&P). In order to clarify the calculation of AAA and AE&P allocated to qualified distributions, these proposed regulations provide two ratios for purposes of characterizing the portion of a qualified distribution that is sourced from AAA (AAA ratio) and from AE&P (AE&P ratio).

The numerator and denominator of the AAA ratio and the AE&P ratio are comprised of two factors: the ETSC's historical AAA and its historical AE&P. An ETSC's AAA ratio would be the fraction of which the numerator is its historical AAA, and the denominator is the sum of its historical AAA and its historical AE&P. An ETSC's AE&P ratio would be the fraction of which the numerator is its historical AE&P, and the denominator is the sum of its historical AAA and its historical AE&P. Generally, the amount of a qualified distribution sourced from AAA would be determined by multiplying the amount of the qualified distribution by the ETSC's AAA ratio. A parallel computation would be undertaken to determine the amount that is sourced from AE&P. Part II.C of this Explanation of Provisions describes the rules relating to the application of the ETSC proration to qualified distributions in greater detail.

3. Coordinating ETSC Proration with Sections 301 and 316

In constructing the mechanics of the ETSC proration, the Treasury Department and the IRS sought to harmonize the rules set forth in section 1371(f) with the general section 301(c) characterization and section 316 allocation rules that govern distributions by a C corporation with respect to its stock. Generally, a distribution by a C corporation with respect to its stock is characterized as a dividend (as defined in section 316), then as a return of stock basis, and finally any remaining amount as gain from the sale or exchange of property. See sections 301(a) and (c). In defining a dividend, section 316 provides that "every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits." Section 316(a)(2) (flush language). Section 1.316-2(a) provides that "[i]n determining the source of a distribution, consideration should be given first[] to the earnings and profits of the taxable year…." Section 1.316-2(b) further provides that, if distributions during the taxable year consist only of money and exceed the amount of the C corporation's current earnings and profits (CE&P) for the taxable year, CE&P is allocated proportionately to such distributions, while AE&P is allocated on a "first-come-first-served" basis.

Section 1371(f), however, provides special rules with respect to qualified distributions that depart from the general section 301(c) characterization and section 316 allocation rules. From the perspective of sections 301 and 316, 1371(f) is thus an exception to those provisions. See section 301(a) (providing an exception for provisions contained in chapter 1 of subtitle A of title 26 of the Code); section 316(a) (providing an exception for provisions contained in subtitle A of title 26 of the Code). Specifically, section 1371(f) provides that, instead of characterizing a qualified distribution as a dividend as defined in section 316, first AAA "shall be allocated to such [qualified] distribution, and the [qualified] distribution shall be chargeable to [AE&P], in the same ratio as the amount of such [AAA] bears to the amount of such [AE&P]." The allocation of AAA ahead of CE&P, and the allocation of AE&P to a distribution ahead of CE&P, depart from the general characterization rules of section 301 and the general section 316 allocation rules

The Treasury Department and the IRS are aware that this special AE&P allocation rule could impact the normal allocation of AE&P, as well as CE&P, to non-qualified distributions by an ETSC, if an ETSC makes non-qualified and qualified distributions during the same taxable year. For example, the following could result when an ETSC makes a non-qualified distribution followed by a qualified distribution during its taxable year. First, the non-qualified distribution could be allocated an amount of AE&P less than the amount that otherwise would be required under the general section 316 allocation rules, because section 1371(f) would require that a portion of the ETSC's AE&P be allocated instead to the "later-in-time" qualified distribution. Second, because section 1371(f) would cause the "earlier-in-time" non-qualified distribution to be allocated a reduced amount of AE&P, the non-qualified distribution could be characterized differently than it otherwise would have been characterized absent section 1371(f) (that is, a characterization described in section 301(c)(2) or section 301(c)(3), rather than section 301(c)(1)).

With regard to the predictable impacts on the treatment and characterization of non-qualified distributions that result from Congress' specific inclusion of AE&P in section 1371(f)'s AAA allocation methodology, the Treasury Department and the IRS have determined that the exceptions set forth in sections 301(a) and 316(a) naturally extend to such consequences as well. Based on the language of these Code sections, as well as Congress' objective to ease affected taxpayers' transition from S corporation status to C corporation status, the proposed regulations provide a special sourcing rule (Section 1371(f) Priority Rule) for qualified distributions, as described in detail in Part II.C of this Explanation of Provisions.

C. Character and Effect of Distributions during the ETSC Period

The Section 1371(f) Priority Rule essentially provides that, during the ETSC period, the rules of the ETSC proration under section 1371(f) apply before the rules of section 301 and 316. Thus, under the Section 1371(f) Priority rule, the ETSC proration first applies to qualified distributions during the taxable year. Then, the rules of section 301 and 316, as incorporated into the Section 1371(f) Priority Rule, apply to any non-qualified distributions as well as to any qualified distributions or portions thereof that are not fully accounted for by the ETSC proration (i.e., because the corporation's AAA or AE&P are exhausted during the year).

The Treasury Department and the IRS acknowledge that the application of the Section 1371(f) Priority Rule, as set forth in these proposed regulations, departs from the allocation and characterization rules under sections 301 and 316 with which taxpayers and practitioners are familiar. The departure is greatest when an ETSC has both historical AAA and historical AE&P and makes both qualified and non-qualified distributions during the same taxable year. For ETSCs with historical AAA but no historical AE&P, which the Treasury Department and the IRS believe will be the most common situation, the departure is less significant and is the same as the departure that section 1371(e) requires for distributions of AAA during the PTTP. Immediately following the end of the taxable year in which the ETSC period ends, which occurs when the ETSC's AAA balance is reduced to zero, the normal rules of section 301 and section 316 apply as usual to all distributions. These proposed regulations are expected to generally reduce the length of the ETSC period and thus reduce the time during which the departure from the normal rules of sections 301 and 316 occurs.

The following summary provides a reference to taxpayers and practitioners for applying the Section 1371(f) Priority Rule to qualified and non-qualified distributions made during the taxable years of the ETSC period, including the taxable year in which the ETSC period ends.

1. Determination of the AAA Ratio and the AE&P Ratio

The Section 1371(f) Priority Rule applies the ETSC proration to each qualified distribution. To determine the ETSC proration, the AAA ratio and the AE&P ratio must first be calculated. An ETSC's AAA ratio is the fraction of which the numerator is its historical AAA and the denominator is the sum of its historical AAA and historical AE&P.

Likewise, an ETSC's AE&P ratio is the fraction of which the numerator is its historical AE&P, and the denominator is the sum of its historical AAA and historical AE&P.

In general, the AAA ratio and the AE&P ratio do not change over the course of the ETSC period. However, if the application of the AE&P ratio to a qualified distribution reduces the ETSC's AE&P to zero, and the ETSC's historical AAA has not been exhausted, then the AAA ratio is one and the AE&P ratio is zero for the remainder of the year and all subsequent taxable years of the ETSC period. Additionally, if the ETSC's AE&P (which includes its historical AE&P) is less than or equal to zero as of the beginning of a taxable year (for example, due to non-qualified distributions or losses incurred during the prior taxable year) and the ETSC's historical AAA has not been exhausted, then the AAA ratio is one and the AE&P ratio is zero for the year and all subsequent taxable years of the ETSC period. These mechanics are responsive to the exhaustion of the ETSC's historical AE&P, and therefore accelerate the distribution of AAA by permitting the entirety of all subsequent qualified distributions to be sourced from the ETSC's AAA.

2. Identification of Qualified and Non-Qualified Distributions during Taxable Year

Application of the Section 1371(f) Priority Rule depends, in part, upon whether a distribution by an ETSC is a qualified or non-qualified distribution. As a result, for each taxable year of an ETSC, each distribution must be characterized as a qualified distribution or a non-qualified distribution before determining the characterization of such distribution under the Section 1371(f) Priority Rule.

3. Characterization and Consequences of Qualified Distributions

For each taxable year of the ETSC period, including the taxable year in which the ETSC period ends, the characterization of each qualified distribution must be determined prior to the characterization of each non-qualified distribution. The portion of a qualified distribution that is sourced from AAA is equal to the lesser of (i) the product of the qualified distribution and the AAA ratio, and (ii) the ETSC's AAA immediately before the qualified distribution. Such AAA-sourced portion of the qualified distribution reduces both the ETSC's AAA and the shareholder's adjusted stock basis, applying the principles of section 301(c)(2). If the amount of that AAA-sourced portion exceeds the shareholder's stock basis, the excess is treated as gain from the sale or exchange of property, regardless of whether the corporation has CE&P or AE&P available. If the amount sourced from AAA equals the balance of the ETSC's AAA before the qualified distribution, all subsequent distributions by the ETSC are treated in the manner provided in section 301(c). If the amount sourced from AAA is less than that balance, then any remaining AAA is available to be allocated to later qualified distributions during the taxable year. If any AAA remains after all qualified distributions for the taxable year have been accounted for, it is carried forward to the next taxable year of the ETSC.

The portion of a qualified distribution that is charged to AE&P is equal to the lesser of (i) the product of the qualified distribution and the AE&P ratio, and (ii) the ETSC's AE&P immediately before the qualified distribution. The ETSC's AE&P is reduced by the charged amount in accordance with section 312(a)(1). The ETSC's AE&P is reduced by the portion of the qualified distribution chargeable to AE&P prior to the application of the rules of sections 301 and 316, as incorporated into the Section

1371(f) Priority Rule, to any non-qualified distribution, regardless of whether the non-qualified distribution occurred prior to the qualified distribution. The amount of the qualified distribution that is charged to the ETSC's AE&P is included in the gross income of the shareholder as a dividend under section 301(c)(1).

4. Application of ETSC proration to excess qualified distributions

Any portion of a qualified distribution that is not initially accounted for by the ETSC proration is referred to as an "excess qualified distribution." An excess qualified distribution arises when the ETSC no longer has AAA, AE&P, or both after initially applying the ETSC proration. If the initial application of the ETSC proration to a qualified distribution does not fully account for the amount of the distribution and the ETSC continues to have AAA, the Section 1371(f) Priority Rule requires that the ETSC proration be reapplied to the excess qualified distribution as if the excess qualified distribution were a separate qualified distribution using a AAA ratio of one and an AE&P ratio of zero. See Part II.C.1 of this Explanation of Provisions.

5. Characterization and Consequences of Non-Qualified Distributions and Excess Qualified Distributions

The Section 1371(f) Priority Rule requires non-qualified distributions and excess qualified distributions (to the extent not characterized as a distribution of AAA) to be treated in the manner described in section 301(c). The Section 1371(f) Priority Rule requires that such treatment take into account the treatment of each non-qualified distribution and each excess qualified distribution made by the ETSC during the same taxable year.

6. Requests for Comments

The Treasury Department and the IRS evaluated several other approaches to implementing section 1371(f) and the rules that would be needed to coordinate those approaches with the rules of sections 301 and 316 before settling on the approach adopted in the Section 1371(f) Priority Rule. The Treasury Department and the IRS request comments regarding the advantages and disadvantages of the Section 1371(f) Priority Rule as well as other proposals that would help ease the transition of S corporation status to C corporation status. The Treasury Department and the IRS also request comments regarding the effect of section 381(a) transactions in which an ETSC is either the transferor or the acquiring corporation (including certain triangular acquisitions) as well as the effect of an ETSC electing to file a consolidated return or joining a consolidated group. The Treasury Department and the IRS further request comments on the effect of subchapter C transactions (including section 302(a) redemptions, section 355 transactions, and section 368 reorganizations) and the effect of a deemed distribution (including forgiveness of shareholder debt) on the ETSC's AAA balance.

III. Amendment of §1.316-2 to Clarify Allocation of CE&P to Non-Cash Distributions

Section 316(a) provides that a dividend is a distribution of property made by a corporation to its shareholders out of its CE&P or AE&P, or both. Pursuant to §1.316-2(a), in determining the source of a distribution under section 316(a), a corporation must first source the distribution from its CE&P before sourcing such distribution from AE&P. If the corporation's CE&P is sufficient to cover "all the distributions" made during the taxable year, then the entirety of each distribution is taxable as a dividend pursuant to the first sentence of §1.316-2(b). If a corporation's distributions during the taxable year consist “only of money” and exceed CE&P, each distribution is allocated its ratable share of CE&P pursuant to the second sentence of §1.316-2(b).

The reference to distributions that “consist only of money” has been in the second sentence of §1.316-2(b) since that regulation was adopted in 1955. Section 1.316-2 was adopted shortly after the enactment of the Internal Revenue Code of 1954 (1954 Code), which contained several provisions relating to distributions of noncash property. A number of these provisions have since changed. In particular, section 311 of the 1954 Code provided that a distributing corporation generally did not recognize any gain or loss on the distribution of noncash property, and section 312 of the 1954 Code provided that the distributing corporation generally reduced its earnings and profits by the adjusted basis of the property distributed. At the same time, section 301(b) of the 1954 Code provided that the amount of a distribution of noncash property to a shareholder depended on the type of shareholder. Individual shareholders were treated as receiving a distribution equal to the fair market value of the property, while corporate shareholders were generally treated as receiving a distribution equal to the lesser of the property’s fair market value or the distributing corporation’s adjusted basis in the asset distributed. In light of these provisions, the 1955 promulgation of §1.316-2 illustrated the consequences of the allocation of CE&P in the simplest fact pattern -- when the distributions consist only of money.

Under current law, however, a distributing corporation recognizes gain on a section 301 distribution of appreciated noncash property. See section 311. The amount of a distribution of noncash property for purposes of shareholder taxation equals the property’s fair market value, irrespective of whether the shareholder is an individual or a corporation. Additionally, section 316(a)(2) makes no distinction between distributions in cash and distributions of other property under section 301. Section 317(a), which section 301 cross-references for purposes of defining property, includes money, securities, and any other property, except a distributing corporation's own stock. Accordingly, the Treasury Department and the IRS do not believe that the language in the second sentence of §1.316-2(b) should be interpreted as implying that under current law the application of the pro rata allocation rule for CE&P is limited to distributions made only in money. Cf. GCM 36138 (Jan. 15, 1975) (noting that "[section] 316(a)(2) makes no qualitative distinction between distributions in cash and other distributions of property under [section] 301," and "[t]hus, there is no basis under [section] 316(a)(2) for limiting the application of the rules under [§]1.316-2(b) to distributions made solely in money"). Therefore, in order to clarify that the pro rata allocation of CE&P applies to all section 301 distributions made during the taxable year, whether in cash or in kind, the proposed regulations would remove the words "consist only of money and" from the second sentence of paragraph (b).

IV. <u>Amendment of §1.1377-2 to Allow for New Shareholders during the PTTP</u>

The last sentence of §1.1377-2(b) limits the special treatment provided under section 1371(e)(1) (that is, the PTTP) solely to those shareholders who were shareholders of the S corporation at the time of termination or revocation of its S election. Because the rules pertaining to the PTTP and to the ETSC period serve the similar objective of easing the transition from S corporation status to C corporation status, the Treasury Department and the IRS have determined that these rules regarding newcomers should be consistent. Therefore, based on the rationale for rejecting a no-newcomer rule for the ETSC period, as set forth in Part II.A of this Explanation of Provisions, the Treasury Department and the IRS have determined that a no-newcomer rule should also not apply to the PTTP. The Treasury Department and the IRS request comments regarding this determination.

Proposed Applicability Dates

The regulations are proposed to apply to taxable years beginning after the date of publication of the Treasury decision adopting these regulations as final regulations in the **Federal Register**. However, the proposed regulations provide corporations with the option to apply the final rules in §§1.316-2, 1.481-5, 1.1371-1, 1.1371-2, and 1.1377-2 in their entirety, to the extent applicable, to taxable years that began on or before the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register** and with respect to which the period described in section 6511(a) has not expired. If the corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

I. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations under sections 481(d), 1371(f), and 1377 of the Code will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. Notwithstanding this certification, the Treasury Department and the IRS invite comments on the impact that these proposed regulations would have on small entities.

These proposed regulations generally affect corporations, and their shareholders, that convert from being taxed as an S corporation to being taxed as a C corporation. The Treasury Department and the IRS acknowledge that there is a substantial number of small entities that are S corporations that could convert to being taxed as a C corporation. According to the 2013 Corporate Income Tax Returns Complete Report (https://www.irs.gov/pub/irs-soi/13coccr.pdf), approximately 83 percent of S corporations had gross receipts under $1,000,000. However, the proposed regulations under section 1371(f) are limited to corporations that:

(i) Revoke their S elections;

(ii) Make their revocations during a specified two-year period beginning on December 22, 2017;

(iii) Have positive AAA at the conclusion of their PTTP; and

(iv) Have the same shareholders (and in identical proportions) on December 22, 2017, and the date the S election revocation is made (shareholder identity requirement).

Because these proposed regulations apply only to those S corporations that satisfy the criteria above, only a small subset of S corporations will be affected.

The U.S. Department of Treasury, Internal Revenue Service, Data Book 2018 (Data Book) (https://www.irs.gov/pub/irs-soi/18databk.pdf) reports that the IRS received approximately 5.1 million S corporation income tax returns in 2018. According to the

Compliance Data Warehouse (CDW), between January 1, 2018, and December 31, 2018, 4,850 S corporations terminated their S elections. Of the 4,850 terminated S corporations:

(i) 286 corporations had more than $35 million in gross receipts;

(ii) 81 corporations had between $25-$35 million in gross receipts;

(iii) 161 corporations had between $15-$25 million in gross receipts; and

(iv) 3,011 corporations had less than $15 million, but at least $1 in gross receipts.

In addition, of those 4,850 terminated S corporations:

(i) 694 corporations reported no gross receipts; and

(ii) The remaining 617 did not file a final return after terminating their S election.

A revocation is one of the three methods by which a corporation may terminate its S election under section 1362(d). Proposed §§1.481-5, 1371-1, and 1371-2 apply only to those corporations that revoke their S election. The CDW does not identify how many of the 4,850 terminations were revocations. In the unlikely scenario that all 4,850 terminations were revocations, approximately 0.0951 percent of the 5.1 million S corporations in existence in 2018 may be affected by these proposed regulations. Extrapolating from the first-year data (January 1, 2018, to December 31, 2018) to the second half of the two-year period (January 1, 2019, to December 21, 2019) during which these proposed regulations are effective, it is possible another 4,850 former S corporations could be affected by these proposed regulations. Thus, these proposed regulations might only affect a total of 9,700 corporations. Assuming that the IRS again receives 5.1 million S corporation income tax returns for the 2019 tax year, these proposed regulations may affect approximately 0.1902 percent of all S corporations in existence in 2018 and 2019. The exact number may be lower because not all terminations are revocations, and a revocation only satisfies one of several criteria that cause these proposed regulations to be applicable. For these proposed regulations to be applicable, the corporation must also have a positive AAA balance at the conclusion of its PTTP and satisfy the shareholder identity requirement. Therefore, the number of affected corporations is likely to be lower.

The other proposed regulation in this notice of proposed rulemaking, proposed §1.1377-2(b), generally applies to a corporation that terminates its S election with a positive AAA balance, regardless of when or how the termination occurs (see section 1362(d)). As a result, the change made by proposed regulation §1.1377-2(b) to allow newcomer shareholders will affect a greater number of terminating S corporations than proposed regulation §§1.481-5, 1.1371-1, and 1.1371-2. Nevertheless, the number of corporations that terminate their S election remains minimal. According to the CDW, there were 2,798 S corporation terminations in 2015; 2,960 in 2016; 3,125 in 2017; and 4,850 in 2018. When comparing the number of terminating S corporations to the number of S corporation income tax returns filed each year, only a small fraction of S corporations will be affected.

In addition, based on published information from the Conference Report accompanying the Act, H.R. Rep. No. 115-446, at 688 (2017), and Bureau of Economic Analysis aggregate data, which were adjusted to reflect the tax burden of small businesses, the projected net tax proceeds from sections 481(d), 1371(f), and 1377 are estimated to affect only a small fraction of the total number of S corporations.

The Treasury Department and the IRS have determined that no additional burden will be associated with these proposed regulations. In particular, the collection of information necessary to comply with these proposed regulations is already required to be collected by previously existing statutory and regulatory requirements. Additionally, these proposed regulations apply only if an S corporation revokes its S election between December 22, 2017 and December 21, 2019, fulfills the shareholder identity requirement, and has a positive AAA balance at the conclusion of its PTTP. The proposed removal of §1.1377-2(b)'s last sentence would reduce a taxpayer's compliance burden by eliminating the need to track shareholders during the PTTP.

For the reasons explained above, the Treasury Department and the IRS have determined that the final regulations will not have a significant economic impact on a substantial number of small entities. Pursuant to section 7805(f), the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

II. Paperwork Reduction Act

These proposed regulations do not require collection of any new or additional information pursuant to the Paperwork Reduction Act (PRA) (44 U.S.C. 3501 <u>et</u> <u>seq</u>.).

The Treasury Department and the IRS intend that the information necessary to apply these proposed regulations will be collected with the following forms that have been previously reviewed and approved by the Office of Management and Budget (OMB) under the PRA:

(i) Form 1120-S, U.S. Income Tax Return for an S Corporation (OMB Control Number 1545-0123);

(ii) Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc. (OMB Control Number 1545-0123);

(iii) Form 1120, U.S. Corporation Income Tax Return (OMB Control Number 1545-0123);

(iv) Form 5452, Corporate Report of Nondividend Distributions (OMB Control Number 1545-0123); and

(v) Form 1099-DIV, Dividends and Distributions (OMB Control Number 1545-0110).

Section 1362(e) requires a corporation that revoked or terminated its S election to file a return for its last taxable year as an S corporation on Form 1120-S. This filing requirement includes an eligible terminated S corporation (ETSC). Section 6037(b) and the regulations thereunder require every S corporation to maintain certain information, such as its shareholders' names, addresses, and other identifying information throughout the taxable year, in order to furnish its shareholders with the information necessary to complete their return (in other words, Schedule K-1). Because sections 1366(a) and 1377(a)(1) allocate an S corporation’s items of income and loss to shareholders on a per-share, per-day basis, every S corporation effectively tracks its shareholders, and their respective ownership percentages, on a daily basis. The information that every S corporation currently collects to comply with the existing requirements of sections 1366(a), 1377(a)(1), and 6037(b) will be used to determine whether a corporation satisfies the shareholder identity requirement of proposed §1.481-5(b)(3).

Any corporation that qualifies as an ETSC will refer to Schedule M-2 of its last filed Form 1120-S to calculate each of its AAA and AE&P ratios, within the meaning of proposed §1.1371-1(a)(2)(vii), to determine its historical AAA and historical AE&P amounts. If an ETSC enters a closing agreement pursuant to a subsequent audit, it will adjust its historical AAA and historical AE&P amounts accordingly.

At the beginning of a corporation's ETSC period, an ETSC will also refer to Schedule M-2 of its last filed Form 1120-S to determine the balance of its accumulated adjustments account (AAA) at the end of its last tax year as an S corporation. If an ETSC makes no cash distributions during its post-termination transition period (PTTP), within the meaning of section 1377(b)(1)(A), then it will start its ETSC period with a AAA balance equal to the amount reported as the AAA balance at the end of the tax year on Schedule M-2 of its last filed Form 1120-S. If an ETSC makes cash distributions during its PTTP, then it will start its ETSC period with a AAA balance equal to the difference between the amount reported as the AAA balance at the end of the tax year on Schedule M-2 of its last filed Form 1120-S and the amount of cash distributions that the ETSC made during its PTTP.

Every domestic C corporation must file an income tax return on Form 1120, and attach Form 5452 if it makes a nondividend distribution to its shareholders. In particular, the instructions for Form 5452 require any corporation that makes a distribution under section 1371(f) to file a Form 5452. In any tax year in which an ETSC makes a qualified distribution, it is required to attach Form 5452 and report its AAA balance, the amount of AE&P at the beginning of the tax year, the amount of CE&P for the current tax year, and the amounts paid during the calendar year from earnings and profits and from "other than earnings and profits." The information collected through Form 5452 is sufficient for an ETSC to apply these proposed regulations. In particular, the information collected through Form 5452 is sufficient for an ETSC to determine its AAA balance both before and after each qualified distribution, as well as determine the impact that each qualified distribution has on its CE&P and AE&P.

With respect to shareholders of ETSC stock, an ETSC is required (like any C corporation that makes a distribution to its shareholders) to provide a statement to its non-corporate recipient shareholders that reports the amounts characterized as a dividend and nondividend distribution on Form 1099-DIV. Form 1099-DIV will inform an ETSC's shareholders of the amount that constitutes a dividend subject to section 301(c)(1) and the amount that constitutes a nondividend distribution. Distributions allocable to AAA will be reported to recipient shareholders as a nondividend distribution. The Treasury Department and the IRS do not anticipate modifying the scope of the information gathered on the aforementioned forms.

Modest burden estimate revisions are anticipated for proposed regulations under §1.1377-2. Specifically, the proposed removal of §1.1377-2(b)'s last sentence would reduce a taxpayer's collection burden by eliminating the need to track shareholders during the PTTP. Changes to these burden estimates will be made in accordance with the PRA in the annual review procedure for information collections under OMB Control Number 1545-0123.

These proposed regulations are estimated to affect a total of 9,700 corporations, or 0.1902% of all S corporations in existence in 2018 and 2019. Regarding proposed regulations §§1.481-5, 1.481-6, 1.1371-2, and 1.1371-3, the exact number might be lower because the 9,700 is extrapolated from data and projections of S corporation terminations, not the subset revocations, and to qualify as an ETSC the corporation must also have a positive AAA balance at the conclusion of its PTTP and satisfy the shareholder identity requirement.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the OMB.

III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2019, that threshold is approximately $164 million. This rule does not include any mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

IV. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial, direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** section. The Treasury Department and the IRS request comments on all aspects of the proposed rules, and specifically on the issues identified in Part I.A.3; in Parts II.B.1 and II.C.6; and in Part IV of this Explanations of Provisions section. All comments will be made available at http://www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, then notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Margaret Burow and Michael Gould of the Office of Associate Chief Counsel (Passthroughs and Special Industries), and Aglaia Ovtchinnikova and Kevin M. Jacobs of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in the development of the proposed regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order for § 1.481-6 to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.481-6 is also issued under 26 U.S.C. 481.

* * * * *

§1.316-2 [Amended]

Par. 2. Section 1.316-2 is amended by removing “consist only of money and” from the second sentence of paragraph (b).

§1.481-5 [Redesignated as §1.481-6]

Par. 3. Section 1.481-5 is redesignated as §1.481-6.

Par. 4. Add new §1.481-5 to read as follows:

<u>§1.481-5 Eligible terminated S corporation</u>.

(a) <u>Scope</u>. Section 481(d)(2) and this section provide rules relating to the qualification of a corporation as an eligible terminated S corporation (ETSC). Paragraph (b) of this section sets forth the requirements a corporation must meet to qualify as an ETSC. Paragraph (c) of this section describes certain transfers and other events that are disregarded for purposes of determining whether a corporation qualifies as an ETSC. Paragraph (d) of this section contains examples illustrating the rules of this section.

(b) ETSC qualification. For a C corporation to qualify as an ETSC, it must satisfy the following requirements:

(1) The corporation must have been an S corporation on December 21, 2017;

(2) During the 2-year period beginning on December 22, 2017, the corporation must have made a valid revocation of its S election under section 1362(d)(1) and the regulatory provisions in this part under section 1362 of the Code (Revocation); and

(3) Except as provided in paragraph (c) of this section, the owners of the shares of stock of the corporation must be the same (and in identical proportions) on both:

(i) December 22, 2017; and

(ii) The day on which the Revocation is made.

(c) Certain disregarded events. The following events are disregarded for purposes of determining whether the requirement in paragraph (b)(3) of this section is satisfied:

(1) Transfers of stock between a shareholder and that shareholder's trust treated as wholly owned by that shareholder under subpart E of subchapter J of chapter 1 of the Code;

(2) Transfers of stock between a shareholder and an entity owned by that shareholder which is disregarded as separate from its owner under §301.7701-2(c)(2)(i) of this chapter;

(3) An election by a shareholder trust to be treated as part of a decedent's estate under section 645 or the termination of an election under that section;

(4) A change in the status of a shareholder trust from one type of eligible S corporation shareholder trust described in section 1361(c)(2)(A) to another type of

eligible S corporation shareholder trust; for example, a trust to which the shares of stock were transferred pursuant to the terms of a will (testamentary trust) described in section 1361(c)(2)(A)(iii) which elects to become an electing small business trust described in section 1361(c)(2)(A)(v) and (e); and

(5) A transaction that includes more than one of the events described in this paragraph (c).

(d) Examples. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (d), as of December 1, 2017, X is a calendar year S corporation with 100 shares of stock outstanding that is owned equally by unrelated individuals A and B. Pursuant to section 1362(d)(1) and §§1.1362-2 and 1.1362-6, X made a valid revocation of its S election on March 15, 2019, effective on January 1, 2019. At all times, X has a single class of stock outstanding. The examples describe all relevant transactions involving the X stock from December 1, 2017 until March 15, 2019.

(1) Example 1--(i) Facts. On June 5, 2018, A contributed 20 of its shares of X stock to Y, a wholly owned limited liability company that is disregarded as an entity separate from A pursuant to §301.7701-2(c)(2)(i) of this chapter. On June 14, 2018, A contributed all of its interest in Y to Trust, which was a revocable trust treated as a wholly owned grantor trust of A pursuant to sections 671 and 676. On December 27, 2018, B sold 10 shares of its X stock to C, an unrelated person.

(ii) Analysis. X is an ETSC if it satisfies the requirements of paragraph (b) of this section.

(A) S corporation. X was an S corporation on December 21, 2017. Therefore, X satisfies the requirement of paragraph (b)(1) of this section.

(B) Date of revocation. X made a valid revocation of its S election pursuant to section 1362(d)(1) on March 15, 2019, which is within the 2-year period specified in paragraph (b)(2) of this section. Therefore, X satisfies the requirement of paragraph (b)(2) of this section.

(C) Ownership. For purposes of the requirement in paragraph (b)(3) of this section, the relevant dates are: December 22, 2017, and March 15, 2019 (the date X made a revocation of its S corporation status).

(1) A's ownership interest. As of December 22, 2017, A owned 50 shares of the outstanding shares of X stock. On June 5, 2018, A contributed 20 of its shares of X stock to Y (Transfer). On June 14, 2018, A contributed all of its interest in Y to Trust (Contribution). Both the Transfer and the Contribution are disregarded for purposes of determining whether the requirement of paragraph (b)(3) of this section is satisfied. See paragraphs (c)(2) and (1) of this section, respectively. Therefore, A owns 50 shares of the outstanding stock of X on March 15, 2019.

(2) B's ownership interest. As of December 22, 2017, B owned 50 shares of the outstanding shares of X stock. On December 27, 2018, B sold 10 shares to C. Therefore, B owns 40 shares of the outstanding stock of X on March 15, 2019.

(3) C's ownership interest. As of December 22, 2017, C owned no shares of X stock. On December 27, 2018, C purchased 10 shares from B. Therefore, C owns 10 shares of the outstanding stock of X on March 15, 2019.

(4) Failure to satisfy the requirement in paragraph (b)(3) of this section. As described in paragraphs (d)(1)(ii)(C)(2) and (3) of this section, B's and C's interest in X were not in the same proportions on December 22, 2017, and March 15, 2019. Therefore, X does not satisfy the requirement of paragraph (b)(3) of this section and does not qualify as an ETSC.

(iii) Restoration of interests prior to end of PTTP. If C transferred its shares of X stock back to B on February 1, 2019, then on December 22, 2017, and March 15, 2019, A and B will have owned 50 shares of the outstanding stock of X. Therefore, X satisfies the requirement of paragraph (b)(3) of this section and qualifies as an ETSC.

(2) Example 2--(i) Facts. The facts are the same as in paragraph (d)(1)(i) of this section (the facts in Example 1), except that B sold 10 shares of its X stock to C on December 18, 2017, in addition to the sale of 10 shares of X stock on December 27, 2018.

(ii) Analysis. The analysis in paragraphs (d)(1)(ii)(A) and (B) of this section remains the same regarding the requirements of paragraphs (b)(1) and (2) of this section. With respect to the requirement of paragraph (b)(3) of this section, on December 22, 2017, A owned 50%, B owned 40%, and C owned 10% of the outstanding stock of X. As in paragraph (d)(1)(ii)(C)(1) of this section, the Transfer and the Contribution are disregarded for purposes of determining whether the requirement of paragraph (b)(3) of this section is satisfied. Therefore, on March 15, 2019, A owned 50% (50 shares), B owned 30% (30 shares), and C owned 20% (20 shares) of the outstanding shares of X. Even though A, B, and C owned shares of X on December 22, 2017, B's and C's proportionate ownership interest of X stock was not the same on December 22, 2017 and March 15, 2019. Therefore, X does not satisfy the requirement of paragraph (b)(3) of this section and does not qualify as an ETSC.

(3) Example 3--(i) Facts. The facts are the same as in paragraph (d)(1)(i) of this section (the facts in Example 1), except that X made a valid revocation of its S election on November 1, 2019, effective on January 1, 2020.

(ii) Analysis. The analysis in paragraphs (d)(1)(ii)(A) through (C) of this section remains the same regarding the requirements of paragraphs (b)(1) through (3) of this section, except that the relevant dates are: December 22, 2017, and November 1, 2019 (the date X made a revocation of its S corporation status). Although the effective date of X's revocation of its S election (January 1, 2020) occurs after the conclusion of the 2-year period specified in paragraph (b)(2) of this section, it is irrelevant for purposes of determining whether the requirements of paragraphs (b)(2) and (3) of this section are satisfied.

Par. 5. Newly redesignated §1.481-6 is amended by revising the section heading and adding three sentences at the end of the paragraph to read as follows:

§1.481-6 Applicability date.

* * * The rules of §1.481-5 generally apply to taxable years beginning after [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**]. However, corporations may choose to apply the rules in §§1.316-2, 1.481-5, 1.1371-1, 1.1371-2, and 1.1377-2 in their entirety, to the extent applicable, to taxable years that began on or before [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**] and with respect to which the period described in section 6511(a) has not expired. If the corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently.

Par. 6. Sections 1.1371-1 and 1.1371-2 are added to read as follows:

§1.1371-1 Distributions of money by an eligible terminated S corporation.

(a) Scope and definitions--(1) Scope. This section provides rules relating to qualified distributions (as defined in paragraph (a)(2)(xii) of this section) and distributions to which section 301 applies during each taxable year of the ETSC period (as defined in paragraph (a)(2)(vii) of this section), including the taxable year in which the ETSC period ends. If the ETSC (as defined in paragraph (a)(2)(vi) of this section) does not make any qualified distributions during a taxable year, then no distribution by the ETSC is governed by section 1371(f) or this section. Paragraph (a)(2) of this section contains definitions that apply for purposes of this section. Paragraph (b) of this section contains rules regarding the characterization of a qualified distribution. Paragraph (c) of this section contains rules regarding the characterization of any excess qualified distribution (as defined in paragraph (a)(2)(viii) of this section) and non-qualified distribution (as defined in paragraph (a)(2)(xi) of this section) during each taxable year of the ETSC period, including the taxable year in which the ETSC period ends. Paragraph (d) of this section contains examples illustrating the rules of this section. Paragraph (e) of this section contains the applicability date of this section.

(2) Definitions. The following definitions apply for purposes of this section--

(i) AAA. The term AAA means the accumulated adjustments account, within the meaning of section 1368(e)(1)(A) and §1.1368-2(a)(1).

(ii) AAA ratio. Except as provided in this paragraph (a)(2)(ii) or paragraph (b)(3)(iv) of this section, the term AAA ratio means the fraction of which the numerator is historical AAA and the denominator is the sum of historical AAA and historical AE&P. Notwithstanding the preceding sentence, if the AE&P of the ETSC is less than or equal to zero as of the beginning of a taxable year, then the AAA ratio is one for such year and all subsequent taxable years of the ETSC period.

(iii) AE&P. The term AE&P means earnings and profits described in section 316(a)(1).

(iv) AE&P ratio. Except as provided in this paragraph (a)(2)(iv) or paragraph (b)(3)(iv) of this section, the term AE&P ratio means the fraction of which the numerator is historical AE&P, and the denominator is the sum of historical AAA and historical AE&P. Notwithstanding the preceding sentence, if the AE&P of the ETSC is less than or equal to zero as of the beginning of a taxable year, then the AE&P ratio is zero for such year and all subsequent taxable years of the ETSC period.

(v) CE&P. The term CE&P means earnings and profits that are described in section 316(a)(2).

(vi) ETSC. The term ETSC means an eligible terminated S corporation, within the meaning of section 481(d) and §1.481-5.

(vii) ETSC period. In general, the term ETSC period means any taxable year, or portion thereof, of an ETSC beginning on the first day after the post-termination period within the meaning of section 1377(b)(1)(A) and ending on the date on which the ETSC's AAA balance is zero. Additionally, an ETSC does not have an ETSC period if the ETSC's AAA balance is not greater than zero at the end of its post-termination transition period. See §1.1371-2 for rules governing the impact of a post-termination period, within the meaning of section 1377(b)(1)(B), on the ETSC period.

(viii) Excess qualified distribution. The term excess qualified distribution means the portion of a qualified distribution that is not characterized pursuant to paragraph (b)(2) or (3) of this section.

(ix) Historical AAA. The term historical AAA means the AAA of the ETSC as of the beginning of the day on which the revocation of an election under section 1362(a) is effective pursuant to section 1362(d)(1).

(x) Historical AE&P. The term historical AE&P means the AE&P of the ETSC as of the beginning of the day on which the revocation of an election under section 1362(a) is effective pursuant to section 1362(d)(1). For purposes of the preceding sentence, if the ETSC's historical AE&P is less than zero, then the historical AE&P is treated as zero.

(xi) Non-qualified distribution. The term non-qualified distribution means a distribution to which section 301 applies, which is not a qualified distribution.

(xii) Qualified distribution. The term qualified distribution means a distribution of money by an ETSC during the ETSC period to which, absent application of section 1371(f) and this section, section 301 would apply.

(b) Characterization of qualified distribution--(1) In general. Paragraph (b)(2) of this section provides rules regarding the determination of the amount of a qualified distribution that is sourced from AAA and the corollary effects of such a characterization. Paragraph (b)(3) of this section provides rules regarding the determination of the amount of a qualified distribution that is sourced from AE&P and the corollary effects of such a characterization. Paragraph (b)(4) of this section provides rules regarding the characterization of an excess qualified distribution as a separate qualified distribution. The rules in paragraphs (b)(2) through (4) of this section are applied before the application of paragraph (c) of this section.

(2) Distribution of AAA--(i) Amount. The portion of a qualified distribution that is sourced from the ETSC's AAA is equal to the lesser of:

(A) The product of the qualified distribution and the AAA ratio; and

(B) The ETSC's AAA immediately before the qualified distribution.

(ii) Reduction or elimination of ETSC's AAA. The ETSC's AAA is reduced by the amount of the distribution described in paragraph (b)(2)(i) of this section. If, with respect to a qualified distribution, the amount described in paragraph (b)(2)(i)(A) of this section equals or exceeds the amount described in paragraph (b)(2)(i)(B) of this section, then the rules in this paragraph (b) do not apply to any subsequent distributions by the ETSC. Instead, the subsequent distributions are treated in the manner provided in paragraph (c) of this section.

(iii) Effect on the shareholder. The amount described in paragraph (b)(2)(i) of this section is applied against and reduces the shareholder's adjusted basis of the shares of stock with respect to which the distribution is made under the principles of section 301(c)(2). If the application of the amount described in paragraph (b)(2)(i) of this section would result in a reduction of basis that exceeds the shareholder's adjusted basis of any share of stock with respect to which the distribution is made, such excess is treated as gain from the sale or exchange of property. The reduction of the shareholder's basis described in this paragraph (b)(2)(iii) with respect to a qualified distribution occurs prior to the application of paragraph (c) of this section to the excess qualified distribution, if any, with respect to such qualified distribution.

(3) Distribution of AE&P--(i) Amount. This paragraph (b)(3) applies if the ETSC's AE&P ratio is greater than zero. If this paragraph (b)(3) applies, the portion of a qualified distribution that is sourced from the ETSC's AE&P is equal to the lesser of:

(A) The product of the qualified distribution and the AE&P ratio; and

(B) The ETSC’s AE&P immediately before the qualified distribution. For purposes of the preceding sentence, if the ETSC’s AE&P immediately before the qualified distribution is less than zero, then the ETSC’s AE&P is treated as zero.

(ii) Effect on ETSC’s AE&P. The ETSC’s AE&P is reduced, as described in section 312(a)(1), by the amount of the distribution described in paragraph (b)(3)(i) of this section. The AE&P reduction described in this paragraph occurs prior to the application of paragraph (c) of this section, even if a distribution to which paragraph (c) of this section applies (regarding excess qualified distributions and non-qualified distributions) occurs earlier in time than the qualified distribution to which this paragraph (b)(3)(ii) applies.

(iii) Effect on the shareholder. The amount of the qualified distribution that is sourced from the ETSC’s AE&P described in paragraph (b)(3)(i) of this section is included in the gross income of the shareholder as a dividend under section 301(c)(1).

(iv) Adjustment to the AAA ratio and the AE&P ratio. After the application of paragraph (b)(3)(ii) of this section, if the ETSC’s AE&P is zero and the ETSC’s AAA is greater than zero, then the ETSC’s AAA ratio is one and the ETSC’s AE&P ratio is zero for all subsequent qualified distributions during:

(A) That taxable year; and

(B) All subsequent taxable years of the ETSC period.

(4) Excess qualified distribution treated as a separate qualified distribution--(i) In general. After the application of paragraph (b)(2)(ii) of this section with respect to a qualified distribution, if the ETSC has any remaining AAA, then any amount of excess

qualified distribution, with respect to such qualified distribution, is treated as a separate qualified distribution and is analyzed pursuant to paragraph (b) of this section.

(ii) No change in characterization of previously characterized portion of qualified distribution. Paragraph (b)(4)(i) will not change the characterization of any portion of a qualified distribution that was previously characterized pursuant to paragraphs (b)(2) and (3) of this section and will reflect the application of paragraphs (b)(2) and (3) of this section to the portion of the qualified distribution previously characterized.

(c) Characterization of excess qualified distribution and non-qualified distributions. After application of paragraph (b) of this section, the excess qualified distributions, if any, and non-qualified distributions, if any, are treated in the manner provided in sections 301(c) and 316.

(d) Examples. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (d), X is a calendar year S corporation with a single share of stock outstanding. A, an individual, purchased its share of X stock prior to December 22, 2017 and, except as otherwise indicated, never contributed any amounts to X's capital. A remained the sole shareholder of X when X made a valid revocation on March 15, 2018, pursuant to section 1362(d)(1) and §1.1362-2 and 1.1362-6, of its S election and when that election became effective on January 1, 2018. X qualified as an ETSC pursuant to §1.481-5(b) and its ETSC period began on January 1, 2019. Additionally, X did not make any distributions during its post-termination transition period, within the meaning of section 1377(b)(1)(A). Furthermore, A remains the sole shareholder of X at the time of the distribution(s) described.

(1) Example 1: Historical AE&P is zero--(i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $0. During 2018, X had $300 of CE&P and

made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $300, and A's adjusted basis in its share of X stock is $460. During 2019, the only distribution that X makes is a $60 distribution of money to A on December 27. X's CE&P during 2019 is $150, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $0. Therefore, X's AAA ratio is 1 ($100/($100 + $0)), and X's AE&P ratio is zero ($0/($100 + $0)).

(B) Characterization of distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $60 distribution on December 27, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) Analysis of qualified distribution--(1) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($60 x 1, or $60), and X's AAA immediately before the qualified distribution ($100). Therefore, $60 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $60 to $40. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $60 to $400.

(2) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($60 x 0, or $0), and X's AE&P immediately before the qualified distribution ($300). Therefore, $0 is sourced from AE&P.

(2) Example 2: Qualified distributions with both historical AAA and historical AE&P--(i) Facts. At the beginning of January 1, 2018, X had AAA of $200 and AE&P of $100. During 2018, X had $0 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $200 and AE&P of $100, and A's adjusted basis in its share of X stock is $500. During 2019, X makes a $90 distribution of money on February 9 and a $150 distribution of money on June 5. X's CE&P during 2019 is $500, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $200 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.67 ($200/($200 + $100)), and X's AE&P ratio is 0.33 ($100/($200 + $100)).

(B) Characterization of distributions. Pursuant to paragraph (a)(2)(xii) of this section, the $90 distribution on February 9, 2019, and the $150 distribution on June 5, 2019, are both qualified distributions because they are distributions of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) Analysis of qualified distributions--(1) February 9, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($90 x 0.67, or $60), and X's AAA immediately before the qualified distribution ($200). Therefore, $60 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $60 to $140. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $60 to $440.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($90 x 0.33, or $30), and X's AE&P immediately before the qualified distribution ($100). Therefore, $30 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $30 to $70. Pursuant to paragraph (b)(3)(iii) of this section, the $30 distribution is characterized as a dividend.

(2) June 5, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($150 x 0.67, or $100), and X's AAA immediately before the qualified distribution ($140). Therefore, $100 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $100 to $40. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $100 to $340.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($150 x 0.33, or $50), and X's AE&P immediately before the qualified distribution ($70). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $20. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(3) Example 3: Limitation on amount characterized as AAA--(i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $300. During 2018, X had $280 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $580, and A's adjusted basis in its share of X stock is $450. During 2019, the only distribution that X makes is a $500 distribution of money to

A on October 5. X’s CE&P during 2019 is $150, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X’s historical AAA and X’s historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X’s election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X’s historical AAA is $100 and X’s historical AE&P is $300. Therefore, X’s AAA ratio is 0.25 ($100/($100 + $300)), and X’s AE&P ratio is 0.75 ($300/($100 + $300)).

(B) Characterization of distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $500 distribution on October 5, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(C) Analysis of qualified distribution--(1) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the qualified distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($500 x 0.25, or $125), and X’s AAA immediately before the qualified distribution ($100). Therefore, $100 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X’s AAA is reduced by $100 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A’s basis in its X stock is reduced by $100 to $350.

(2) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($500 x 0.75, or $375), and X’s AE&P immediately before the qualified distribution ($580). Therefore, $375 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X’s AE&P is reduced by $375 to $205. Pursuant to paragraph (b)(3)(iii) of this section, the $375 distribution is characterized as a dividend.

(D) Effect of qualified distribution on ETSC period. Pursuant to paragraph (a)(2)(vii) of this section, X’s ETSC period ends because X’s AAA balance is zero following the October 5, 2019 distribution.

(E) Analysis of excess qualified distribution--(1) Amount of excess qualified distribution. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $25, the portion of the qualified distribution ($500) not characterized pursuant to paragraph (b)(2) or (3) of this section ($100 AAA distribution + $375 AE&P distribution).

(2) Characterization of excess qualified distribution. Paragraph (b)(4) of this section does not apply to the excess qualified distribution because X’s AAA balance is zero after the application of paragraph (b)(2)(ii) of this section (see paragraph (d)(3)(ii)(C)(1) of this section). Pursuant to paragraph (c) of this section, section 301(c)

applies to the excess qualified distribution. Pursuant to sections 301(c)(1) and 316, the $25 excess qualified distribution is sourced from CE&P.

(iii) Subsequent contribution. The facts are the same as paragraph (d)(3)(i) of this section, except that at the time of the October 5, 2019 distribution, A's adjusted basis in its X stock is $90. Further, on December 27, 2019, A contributes $100 to X in a transaction described in section 351(a). The analysis in paragraph (d)(3)(ii) of this section remains the same, except that, unlike the second to last sentence of paragraph (d)(3)(ii)(C)(1) of this section, A's basis in its X stock is reduced by $90 to $0 and pursuant to paragraph (b)(2)(iii) of this section, $10 is treated as gain from the sale or exchange of property. Additionally, as a result of the December 27, 2019 contribution of $100, A's basis in its X stock is increased by $100, so that at the end of 2019, A's basis in its X stock is $100.

(4) Example 4: Limitation on the amount characterized as AE&P--(i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $100. During 2018, X had CE&P of $(75) and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $25, and A's adjusted basis in its share of X stock is $500. During 2019, the only distributions that X makes are a $100 distribution of money to A on July 9 and a $40 distribution of money to A on September 27. X's CE&P during 2019 is $20, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA and X's historical AE&P are determined as of the beginning of January 1, 2018, the beginning of the day on which the revocation of X's election under section 1362(a) is effective pursuant to section 1362(d)(1). Accordingly, X's historical AAA is $100 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.5 ($100/($100 + $100)), and X's AE&P ratio is 0.5 ($100/($100 + $100)).

(B) Analysis of July 9, 2019 distribution--(1) Characterization of distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $100 distribution on July 9, 2019, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(2) Analysis of qualified distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($100 x 0.5, or $50), and X's AAA immediately before the qualified distribution ($100). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $50. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $50 to $450.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($100 x 0.5, or $50), and X's AE&P immediately before the qualified distribution ($25). Therefore, $25 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $25 to $0. Pursuant to paragraph (b)(3)(iii) of this section, the $25 distribution is characterized as a dividend.

(3) Recalculation of AAA and AE&P ratios. Pursuant to paragraph (b)(3)(iv) of this section, because the July 9, 2019 distribution caused X's AE&P to be reduced to zero, the AAA ratio is one and the AE&P ratio is zero for all subsequent qualified distributions during the 2019 taxable year and subsequent taxable years of the ETSC period.

(4) Excess qualified distribution--(i) Amount of excess qualified distribution. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $25, the amount of the qualified distribution ($100) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $25 AE&P distribution).

(ii) Characterization of excess qualified distribution as a separate qualified distribution. Pursuant to paragraph (b)(4) of this section, because X has AAA remaining after characterizing the qualified distribution (see paragraph (d)(4)(ii)(B)(2)(i) of this section), the $25 excess qualified distribution is treated as a separate qualified distribution and is analyzed pursuant to paragraph (b) of this section.

(iii) Analysis of excess qualified distribution that is treated as a separate qualified distribution. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the excess qualified distribution and the AAA ratio ($25 x 1, or $25), and X's AAA immediately before the excess qualified distribution ($50). Therefore, $25 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $25 to $25. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $25 to $425. Pursuant to paragraph (b)(3)(i) of this section, because X's AE&P ratio is zero, paragraph (b)(3) of this section does not apply.

(C) Analysis of September 27, 2020 distribution--(1) Characterization of the distribution. Pursuant to paragraph (a)(2)(xii) of this section, the $40 distribution on September 27, 2020, is a qualified distribution because it is a distribution of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section.

(2) Analysis of qualified distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($40 x 1, or $40), and X's AAA immediately before the qualified distribution ($25) (see paragraph (d)(4)(ii)(B)(4)(iii) of this section). Therefore, $25 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced

by $25 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A's basis in its X stock is reduced by $25 to $400.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, because X's AE&P ratio is zero, paragraph (b)(3) of this section does not apply.

(3) Excess qualified distribution--(i) Amount of excess qualified distribution. Pursuant to paragraph (a)(2)(viii) of this section, the amount of the excess qualified distribution is $15, the portion of the qualified distribution ($40) not characterized pursuant to paragraph (b)(2) or (3) of this section ($25 AAA distribution + $0 AE&P distribution).

(ii) Excess qualified distribution not characterized as a separate qualified distribution. Pursuant to paragraph (b)(4) of this section, because X has AAA of $0 after characterizing the qualified distribution (see paragraph (d)(4)(ii)(C)(2)(i) of this of this section), the $15 excess qualified distribution is not treated as a separate qualified distribution.

(iii) Analysis of excess qualified distribution that is not treated as a separate qualified distribution. Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to sections 301(c)(1) and 316, the $15 excess qualified distribution is sourced from CE&P.

(5) Example 5: Distributions include non-qualified distributions--(i) Facts. At the beginning of January 1, 2018, X had AAA of $100 and AE&P of $100. During 2018, X had $0 of CE&P and made no distributions. At the beginning of January 1, 2019, X has AAA of $100 and AE&P of $100, and A's adjusted basis in its X stock is $200. During 2019, X makes a $100 distribution of money on June 14; a $300 distribution of property on November 9; and a $200 distribution of money on December 18. X's CE&P during 2019 is $160, without diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Calculation of AAA ratio and AE&P ratio. Pursuant to paragraphs (a)(2)(ix) and (x) of this section, respectively, X's historical AAA is $100 and X's historical AE&P is $100. Therefore, X's AAA ratio is 0.5 ($100/($100 + $100)), and X's AE&P ratio is 0.5 ($100/($100 + $100)).

(B) Characterization of distributions. Pursuant to paragraph (a)(2)(xii) of this section, the $100 distribution on June 14, 2019, and the $200 distribution on December 18, 2019, are both qualified distributions because they are distributions of money by an ETSC during the ETSC period to which section 301 would apply absent the application of section 1371(f) and this section. Pursuant to paragraph (a)(2)(xi) of this section, the $300 distribution of property on November 9, 2019, is non-qualified distribution. Pursuant to paragraph (b)(1) of this section, the rules of paragraphs (b)(2) through (4) of this section apply to the qualified distributions before the rules of paragraph (c) of this section apply to the non-qualified distribution and any excess qualified distributions.

(C) Analysis of qualified distributions--(1) June 14, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($100 x 0.5, or $50), and X's AAA immediately before the qualified distribution ($100). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $50. Pursuant to paragraph (b)(2)(iii) of this section, on June 14, 2019, A's basis in its X stock is reduced by $50 to $150.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($100 x 0.5, or $50), and X's AE&P immediately before the qualified distribution ($100). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $50. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(iii) Amount of excess qualified distribution. The amount of the excess qualified distribution is $0, the amount of the qualified distribution ($100) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $50 AE&P distribution).

(2) December 18, 2019 distribution--(i) Distribution of AAA. Pursuant to paragraph (b)(2)(i) of this section, the portion of the distribution that is sourced from AAA is equal to the lesser of: the product of the qualified distribution and the AAA ratio ($200 x 0.5, or $100), and X's AAA immediately before the qualified distribution ($50). Therefore, $50 is sourced from AAA. Pursuant to paragraph (b)(2)(ii) of this section, after the distribution, X's AAA is reduced by $50 to $0. Pursuant to paragraph (b)(2)(iii) of this section, A must determine its basis as of December 18, 2019, in order to determine the consequences of receiving the $50 AAA distribution. Because the non-qualified distribution on November 9, 2019, which precedes the December 18, 2019 qualified distribution, could have the effect of reducing A's basis, any effect on A's basis from that non-qualified distribution must be analyzed prior to determining the effect of the December 18, 2019 distribution of AAA on A's basis. See paragraphs (d)(5)(ii)(D)(3) and (4) of this section. Pursuant to paragraph (a)(2)(vii) of this section, X's ETSC period ends because X's AAA balance is zero following the December 18, 2019 distribution.

(ii) Distribution of AE&P. Pursuant to paragraph (b)(3)(i) of this section, the portion of the distribution that is sourced from AE&P is equal to the lesser of: the product of the qualified distribution and the AE&P ratio ($200 x 0.5, or $100), and X's AE&P immediately before the qualified distribution ($50). Therefore, $50 is sourced from AE&P. Pursuant to paragraph (b)(3)(ii) of this section, after the distribution, X's AE&P is reduced by $50 to $0. Pursuant to paragraph (b)(3)(iii) of this section, the $50 distribution is characterized as a dividend.

(iii) Amount of excess qualified distribution. The amount of the excess qualified distribution is $100, the amount of the qualified distribution ($200) not characterized pursuant to paragraph (b)(2) or (3) of this section ($50 AAA distribution + $50 AE&P distribution).

(D) Analysis of non-qualified and excess qualified distributions--(1) In general. The $300 non-qualified distribution on November 9, 2019, and the $100 excess qualified distribution on December 18, 2019, are treated in the manner provided in section 301(c).

(2) Allocation of CE&P. Pursuant to section 316 and §1.316-2, X's CE&P is allocated proportionately among the excess qualified and the non-qualified distributions. Therefore, the portion of X's CE&P that is allocated to the November 9, 2019 distribution and the December 18, 2019 distribution is $120 ($160 X's CE&P x ($300 distribution / $400 total excess qualified and non-qualified distributions during 2019) and $40 ($160 X's CE&P x ($100 distribution / $400 total excess qualified and non-qualified distributions during 2019), respectively.

(3) November 9, 2019 distribution. Pursuant to paragraph (d)(5)(ii)(D)(2) of this section, $120 of the $300 distribution is characterized as a distribution of CE&P. Pursuant to paragraph (d)(5)(ii)(C)(2)(ii) of this section, the amount of X's AE&P available to allocate the November 9, 2019 distribution is $0. Therefore the remaining $180 is characterized pursuant to section 301(c)(2) and (3). Pursuant to paragraph (d)(5)(ii)(C)(1)(i) of this section, A's basis in its X stock prior to the November 9, 2019 distribution is $150. Therefore, $150 is applied against basis pursuant to section 301(c)(2) (reducing A's basis to $0) and $30 is treated as gain from the sale or exchange of property pursuant to section 301(c)(3).

(4) December 18, 2019 distribution--(i) Consequences of AAA distribution. As of December 18, 2019, A's basis in its X stock is $0. See paragraph (d)(5)(ii)(D)(3) of this section. Pursuant to paragraph (d)(5)(ii)(C)(2)(i) of this section, $50 of the distribution is characterized as a distribution of AAA. Because the amount of the distribution of AAA ($50) exceeds A's basis in its X stock ($0), pursuant to paragraph (b)(2)(iii) of this section, on December 18, 2019, $50 is treated as gain from the sale or exchange of property.

(ii) Characterization of excess qualified distribution. Pursuant to paragraph (d)(5)(ii)(C)(2)(iii) of this section, $100 of the December 18, 2019 distribution is an excess qualified distribution. Paragraph (b)(4) of this section does not apply to the excess qualified distribution because X's AAA balance is zero after the application of paragraph (b)(2)(ii) of this section (see paragraph (d)(5)(ii)(C)(2)(i) of this section). Pursuant to paragraph (c) of this section, section 301(c) applies to the excess qualified distribution. Pursuant to paragraph (d)(5)(ii)(D)(2) of this section, $40 of the $100 excess qualified distribution is characterized as a distribution of CE&P. Pursuant to paragraph (d)(5)(ii)(D)(3) of this section, X's AE&P as the time of the December 18, 2019 distribution is $0. Therefore the remaining $60 is characterized pursuant to section 301(c)(2) and (3). Pursuant to paragraph (d)(5)(ii)(D)(4)(i) of this section, A's basis in its X stock prior to characterization of the excess qualified distribution is $0. Therefore, $60 is treated as gain from the sale or exchange of property pursuant to section 301(c)(3).

(e) Applicability date. This section generally applies to taxable years beginning after [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**]. However, corporations may choose to apply the rules in §§1.316-2, 1.481-5, 1.1371-1, 1.1371-2, and 1.1377-2 in their entirety, to the extent applicable, to taxable years that began on or before [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**] and with respect to which the period described in section 6511(a) has not expired. If the corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently.

§1.1371-2 Impact of Audit PTTP on ETSC Period.

(a) Definitions. For purposes of this section, the definitions used in §1.1371-1(a)(2) are applicable. Additionally, the following definitions apply for purposes of this section--

(1) Audit PTTP. The term audit PTTP means a post-termination transition period described in section 1377(b)(1)(B).

(2) Initial PTTP. The term initial PTTP means a post-termination transition period described in section 1377(b)(1)(A).

(3) Intervening audit PTTP. The term intervening audit PTTP means an audit PTTP arising during the ETSC period.

(b) In general. If an intervening audit PTTP arises, the ETSC period shall immediately stop. Immediately following the end of the intervening audit PTTP, the ETSC period will resume if the ETSC's AAA balance is greater than zero. Otherwise, any subsequent distributions by the ETSC are treated in the manner provided in section 301(c).

(c) Examples. The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (c), X is a calendar year S corporation. A, an individual, purchased all of the outstanding shares of X in a single transaction at the same price per share prior to December 22, 2017, and was the sole shareholder of X at all times. Pursuant to section 1362(d)(1) and §§1.1362-2 and 1.1362-6, X made a valid revocation of its S election on March 15, 2019, that became effective on January 1, 2019. No amount distributed by X is an extraordinary dividend within the meaning of section 1059.

(1) Example 1: No ETSC period following initial PTTP--(i) Facts. At the beginning of January 1, 2019, X had AAA of $49,000 and AE&P of $2,000, and A's adjusted basis in its shares of X stock was $50,000. During 2019, the only distribution that X made was a $49,000 distribution of money to A on March 13, 2019. X's CE&P during 2019 was $0, without regard to any diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Distribution during initial PTTP. Pursuant to sections 1371(e) and 1377(b)(1)(A), the $49,000 distribution of money on March 13, 2019, is characterized as a distribution of AAA because it was made during the initial PTTP.

(B) Effect on corporation. Pursuant to §1.1368-2(a)(3)(iii), X's AAA is reduced by $49,000 to $0. Following the initial PTTP, even if X satisfies the requirements of section 481(d)(2) and §1.481-5(b) to be an ETSC, X does not have an ETSC period because its AAA balance is zero at the end of its initial PTTP. Therefore, section 1371(f) and §1.1371-1 will not apply to any subsequent distributions by X.

(C) Effect on shareholder. Pursuant to section 1371(e)(1), A reduces its basis in its X stock by $49,000 to $1,000.

(2) Example 2: Intervening audit PTTP--(i) Facts. The facts are the same as the facts in paragraph (c)(1) of this section. On May 20, 2020, which is after X's initial PTTP, the IRS begins an audit of X's 2018 return. During the audit it is agreed that X overstated its advertising expense deduction by $10,000. On July 6, 2020, A signs a closing agreement whereby X's overstatement results in an additional tax on A's 2018 individual return. As a result, at the beginning of January 1, 2019, X had AAA of $59,000 ($49,000 + $10,000) and AE&P of $2,000. Additionally, at the beginning of

January 1, 2019, A's adjusted basis in its shares of X stock was $60,000 ($50,000 + $10,000). During 2020, the only distribution X makes is a $6,000 distribution of money to A on September 1, 2020. X's CE&P during 2020 was $0, without regard to any diminution by reason of any distributions made during the taxable year.

(ii) Analysis--(A) Analysis of March 15, 2019 distribution. The treatment of the March 15, 2019, distribution is the same as described in paragraph (c)(1)(ii)(A) of this section, because the amount of the distribution ($49,000) does not exceed X's AAA balance at the beginning of January 1, 2019 ($59,000), and so the entirety of the $49,000 distribution is properly characterized as a distribution of AAA.

(1) Effect on corporation. As described in paragraph (c)(1)(ii)(B) of this section, X's AAA ($59,000 at the beginning of January 1, 2019) is reduced by $49,000 to $10,000. At the conclusion of X's initial PTTP (ending on December 31, 2019), X's AAA balance is $10,000. Pursuant to §1.1371-1(a)(2)(vii), X has an ETSC period. Therefore, section 1371(f) and §1.1371-1 will apply to any subsequent qualified distributions by X.

(2) Effect on shareholder. As described in paragraph (c)(1)(ii)(C) of this section, A reduces its basis in its X stock ($60,000 at the beginning of January 1, 2019) by $49,000 to $11,000.

(B) Intervening audit PTTP. Pursuant to section 1377(b)(1)(B), X enters an intervening audit PTTP that begins on July 6, 2020, and ends on November 2, 2020. The application of section 1371(f) and the regulatory provisions in this part under section 1371 of the Code to distributions during the intervening audit PTTP is stopped. Instead, sections 1371(e) and 1377(b)(1)(B), and the regulatory provisions in this part under sections 1371 and 1377 of the Code, apply for the duration of the intervening audit PTTP. During the intervening audit PTTP, the only distribution X made is a $6,000 distribution of money to A on September 1, 2020. Pursuant to sections 1371(e) and 1377(b)(1)(B), the $6,000 distribution is characterized as a distribution of AAA because it was made during the intervening audit PTTP.

(1) Effect on corporation. Pursuant to §1.1368-2(a)(3)(iii), X's AAA is reduced by $6,000 to $4,000. Beginning on November 3, 2020, pursuant to §1.1371-1(a)(2)(vii), X's ETSC period resumes (after the intervening audit PTTP's conclusion) because its AAA balance is greater than zero.

(2) Effect on shareholder. Pursuant to section 1371(e)(1), A reduces its basis in its X stock by $6,000 to $5,000.

(C) ETSC period. Beginning on November 3, 2020, X's ETSC period resumes, and distributions of money are subject to section 1371(f) and the regulatory provisions in this part under section 1371 of the Code until X's AAA balance is zero. For purposes of calculating each of X's AAA and AE&P ratios, X's historical AAA is $59,000 (at the beginning of January 1, 2019, which includes the $10,000 increase as a result of the July 6, 2020, closing agreement).

(d) Applicability date. This section generally applies to taxable years beginning after [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**]. However, corporations may choose to apply the rules in §§1.316-2, 1.481-5, 1.1371-1, 1.1371-2, and 1.1377-2 in their entirety, to the extent applicable, to taxable years that began on or before [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**] and with respect to which the period described in section 6511(a) has not expired. If the corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently.

§1.1377-2 [Amended]

Par. 7. Section 1.1377-2 is amended by removing the last sentence of paragraph (b).

Par. 8. Section 1.1377-3 is amended by:

a. Removing "and 1.1377-2 apply" and adding "applies" in its place; and

b. Adding three sentences at the end of the paragraph.

The addition reads as follows:

§1.1377-3 Effective dates.

* * * Section 1.1377-2 generally applies to taxable years beginning after [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**], however, corporations may choose to apply the rules in §§1.316-2, 1.481-5, 1.1371-1, 1.1371-2, and 1.1377-2 in their entirety, to the extent applicable, to taxable years that began on or before [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**] and with respect to which the period described in section 6511(a) has not expired. If the corporation makes the choice described in the previous sentence, all shareholders of the corporation must report consistently. For taxable years beginning on or before [DATE OF PUBLICATION OF THE FINAL RULES IN THE **FEDERAL REGISTER**], see §1.1377-2(b) as contained in 26 CFR part 1, revised April 1, 2019.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

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