Table of Contents

8.0 DISTRIBUTIONS/ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

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8.1 THE ACCUMULATED ADJUSTMENTS ACCOUNT (AAA)

The Accumulated Adjustments Account (AAA) is an account of the S Corporation The S Corporation maintains the AAA to track undistributed income that has been taxed during the period its S election is in effect. (Treas. Reg. §1.1368-2(a))

It is not mandatory to track AAA if the S Corporation does not have subchapter C corporation earnings and profits. (Internal Revenue Code (IRC) §1368(b)) However, it may be beneficial to those corporations to maintain the AAA for future purposes. For example, if a corporation with subchapter C earnings and profits is acquired through merger, the S Corporation acquires the AAA of the merged corporation as well as its subchapter C earnings and profits. The taxability of future distributions is computed using the combined AAA. (IRC §381(c)(2) and Treas. Reg. §1.1368-2(d)(2))

The auditor should prepare AAA schedules for all S Corporations regardless of whether the S Corporation has subchapter C earnings and profits.

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8.2 THE IMPORTANCE OF THE ACCUMULATED ADJUSTMENTS ACCOUNT

The importance of AAA is to determine the taxability of distributions at the shareholder level. AAA (to the extent of basis) can be distributed to the shareholders free of further tax at the individual level. If distributions exceed AAA and S Corporation has subchapter C earnings and profits, the excess is applied to reduce any subchapter C earnings and profits remaining at year-end. Distributions from subchapter C earnings and profits are taxable as dividend distributions to the shareholder(s). (IRC §1368(c)(2)) However, if the S Corporation does not have subchapter C earnings and profits, then distributions from AAA are not taxable to the extent of shareholder stock basis (IRC §1368(b)(1)). But, to the extent the distribution exceeds shareholder stock basis, the excess is treated as a capital gain (IRC §1368(b)(2)).

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8.3 DO I HAVE A AAA ISSUE?

In general, adjustments are made to both the shareholder basis and AAA for items of income (losses). (IRC §1368(e)(1)(A)) If aggregate adjustments are positive, the shareholder is not taxed on this amount when actually distributed. In other words, if the distribution is not in excess of the AAA at the time of distribution, it is nontaxable to the shareholder as long as distribution does not exceed shareholder basis.

The following are common situations in which AAA may be an audit issue:

On the S Corporation return, AAA would be an audit issue if the S Corporation, having subchapter C earnings and profits, made distributions during the year that may be in excess of AAA. This information can be found on Schedules K, K-1, and M-2. Schedule M-2 should provide the most information in regards to this issue. If the distribution is greater than the AAA balance before distributions and the S Corporation had subchapter C earnings and profits, you may have an AAA issue. (Note: Schedule M-2 contains a check box for subchapter C earnings and profits. Reporting trends have identified that this box is not consistently checked when subchapter C earnings and profits exist. Do not assume the corporation has no subchapter C earnings and profits if this box is not checked.)

On the other hand, if the S Corporation does not have subchapter C earnings and profits, then AAA does not become an issue. Instead, the taxability of the distributions made by the S Corporation is determined by the adjusted basis of the shareholder's stock (IRC §1368(b)).

In California Revenue and Taxation Code (R&TC) §23800, S Corporation tax treatment is determined in accordance with Subchapter S of the IRC, except as otherwise provided. Within R&TC, there are no special provisions for AAA. Therefore, California follows federal law for maintaining AAA. Treas. Reg. §1.1368-2(a) states, "On the first day of the first year for which the corporation is an S Corporation, the balance of the AAA is zero." Because California did not recognize S Corporations until 1987, there are many instances when federal and California S election dates will be different. As a result, the AAA balance will also be different for federal and California purposes. Auditors should always verify that the AAA they are working with is that of California.

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In addition, California AAA is always different from federal AAA due to federal/state differences such as franchise taxes, depreciation, etc. Compare the federal and California AAA balances to determine whether the corporation made the proper California adjustments.

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8.4 ITEMS AFFECTING AAA (IRC §1368(E), IRC §1367)

IRC §1368(e)(1) defines the Accumulated Adjustments Account (AAA) as follows:

Except as otherwise provided in this paragraph, the term "accumulated adjustments account" means an account of the S Corporation which is adjusted for the S period in a manner similar to the adjustments under IRC §1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in IRC §1367(a)(2))) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

IRC §1367 refers to adjustments to shareholder stock basis whereas IRC §1368(e)(1)(A) refers to adjustments to AAA. Differences between adjustments to shareholder stock basis and AAA are:

- AAA, unlike basis, cannot be increased for tax-exempt income.
- AAA, unlike basis, cannot be decreased for expenses related to tax-exempt income.
- AAA, unlike basis, cannot be decreased for federal taxes attributable to any taxable year in which the corporation was a C corporation.
- AAA, unlike basis, can go below zero.

8.4.1 Pro-Rata Distributive Share Items That Increase AAA

IRC §1368(e)(1)(A); by reference §1367(a)(1)	Also Known As	Specific Income Items
(A) Items of income (excluding tax-exempt income), the separate	Separately stated items	Rental income, real estate and other. Interest and dividend

treatment of which could affect the liability for tax of any shareholder.		income. Royalties. Capital gains. Other portfolio income. IRC §1231 gain. Other income.
(B) Non-separately computed income.	Non-separately stated items	Schedule K-1: Ordinary income from trade or business activities.
(C) The excess of deductions for depletion over the basis of the property subject to depletion.		

In Heller v. Franchise Tax Board, (1994) 21 Cal. App. 4th 1730, the Third Circuit Court of Appeals overturned the department's position that tax-exempt interest income is not included in AAA. The issue addressed whether AAA is based on corporate level taxability. The taxpayer argued that it reported T-bill interest as taxable S Corporation income and paid taxes accordingly at the corporate level, therefore, AAA should be increased. The department will follow the Heller decision and apply it in situations with tax-exempt interest. Therefore, any tax-exempt interest income received by an S Corporation will increase AAA (distinguishable from federal). However, any other source of tax-exempt income will not increase AAA. (IRC §1368(e)(1)(A))

8.4.2 Pro-Rata Distributive Share Items That Decrease AAA

IRC §1368(e)(1)(A); by reference §1367(a)(2)	Also Known As	Specific Income Items
(A) Distributions by the corporation that were not includible in the	Return of capital distributions	

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income of the shareholder by reason of IRC §1368.		
(B) Items of loss or deduction, the separate treatment of which could affect the liability of any shareholder.	Separately stated items	Rental losses, real estate and other. Capital losses. Charitable contributions. Political contributions. Expense deductions for recovery property. Deductions related to portfolio income (loss). Other deductions. Note: Credits are not an item of loss or deduction.
(C) Non-separately computed loss.	Non-separately stated items	Schedule K-1: Ordinary loss from trade or business activities.
(D) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account.	Non-capital, nondeductible expenses	Treas. Reg. §1.1368-2(a)(3)(i)(C) Nondeductible portion of meals and entertainment expenses. Wages that are nondeductible because of targeted jobs tax credit. Research and development expenditures that are not deductible because of the R&D credit. Nondeductible fines and penalties. Nondeductible life insurance premiums. Nondeductible franchise tax.

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		These include only those items for which no loss/deduction is allowable and do not include items the deduction for which is deferred to a later taxable year.
(E) The amount of the shareholder's deduction for depletion for any oil and gas property held by the S Corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under IRC §613A(c)(11)(B).		

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8.5 AAA ORDERING RULES

Like shareholder basis, AAA is adjusted on the last day of the taxable year. Prior to January 1, 1997, the ordering rules for the adjustments (Treas. Reg. §1.1368-2(a)(4)) are as follows:

- Items that increase shareholder basis except tax-exempt income increase AAA;
- Items that decrease shareholder basis except tax exempt deductions and distributions decrease AAA;
  - Ordinary distribution decreases AAA;
  - Redemption distribution can increase or decrease AAA.

The only time AAA balance cannot go below zero is from ordinary distributions (IRC §1368(b) or (c)(1), whichever is applicable).

Note 1: The examples used in the Shareholder Basis (S Corp 9.0) and Distributions/Accumulated Adjustments Account (AAA) (S Corp 8.0) are simplified. They have not been computed on a per day, per share basis as in the Treas. Reg. examples. If you have situations that have multiple stock purchase days, please be aware you need to compute the basis/AAA on a per day, per share basis.

Example A (Prior to 1/1/97)

		AAA
1.	Beginning Balance	$100,000
2.	Ordinary Income	100,000
	Subtotal	200,000
3.	IRC §1231 Loss	-900,000
4.	Ending Balance	-$700,000

Unlike shareholder basis, the IRC §1231 Loss was allowed to reduce AAA below zero.

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Example B (Prior to 1/1/97)

		AAA
1.	Beginning Balance	$0
2.	Ordinary Income	100,000
	Subtotal	100,000
3.	IRC §1231 Loss	-900,000
4.	Subtotal before Distributions	-$800,000
5.	Distributions ($500,000)	0
6.	Ending Balance	-$800,000

No portion of the $500,000 distribution would reduce AAA.

The ordering rules for the adjustments to AAA changed for taxable years on or after August 18, 1998. The new ordering rules allow the S Corporation to disregard any "net negative adjustment" for such taxable year.

A "net negative adjustment" is defined as the excess (if any) of the negative adjustments over the positive adjustments to AAA without considering the distributions (IRC §1368(e)(1)(C)(ii)). If the S Corporation does have a "net negative adjustment", then the ordering rules for the adjustments (Treas. Reg. §1.1368-2(a)(5)) are as follows:

- Items that increase shareholder basis except tax-exempt income increases AAA;
- Items that decrease shareholder basis except tax-exempt deductions, "net negative adjustment", and distributions decrease AAA;
  - Ordinary distribution decreases AAA;
  - A redemption distribution decreases AAA.

Example C - After 8/18/1998 with Net Negative Adjustment

		AAA
1.	Beginning Balance	$100,000
2.	Ordinary Income	100,000
3.	IRC §1231 Loss ($900,000)	-900,000
	Subtotal	$100,000

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4.	Ending Balance	$-700,000

In this example, the shareholder could have received a “tax free” distribution of $100,000.

Example D - After 8/18/98 without Net Negative Adjustment

		AAA
1.	Beginning Balance	$0
2.	Ordinary Income	100,000
3.	IRC §1231 Loss ($900,000)	-100,000
	Subtotal	$0
4.	Distributions ($500,000)	
5.	Ending Balance	$-800,000

No portion of the $500,000 distribution would reduce AAA and the taxability would follow the rules in IRC §1368 by reference from IRC §1368(c)(3).

Example E - After 8/18/98 with No Net Negative Adjustment

		AAA
1.	Beginning Balance	$0
2.	Ordinary Income	400,000
	Subtotal	$400,000
3.	IRC §1231 Loss	-100,000
4.	Subtotal before Distributions	$300,000
5.	Distributions ($500,000)	-300,000
6.	Ending Balance	-$0

The portion of the $500,000 distribution from AAA was $300,000. Taxability of the remainder $200,000 distribution would follow the rules in IRC §1368 by reference from IRC §1368(c)(3). Note that the result is the same for taxable years prior to 1/1/1997 because there are no "net negative adjustments".

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Example F - After 8/18/97

ABC, Inc., a federal and California S Corporation, reported the following "net negative adjustment" for federal purposes in IYE 12/97:

Interest income	$ 100,000
Capital gain	100,000
Ordinary loss from trade or business activities	-500,000
Charitable contributions	-100,000
Net negative adjustment	-400,000

ABC reported a beginning federal AAA balance of $150,000 and made distributions totaling $350,000 in IYE 12/97. ABC would compute its AAA as follows:

		AAA
1.	Beginning Balance	$ 150,000
2.	Distribution ($350,000)	-150,000
	Subtotal	$ 0
3.		$0

Net negative adjustment
-400,000

4.
Ending Balance
-$400,000

ABC disregarded its "net negative adjustment" and reduced AAA by the distribution not in excess of AAA ($150,000).

Note that there is a gap between the effective date of the amendments to IRC §1368 of (taxable years beginning after 12/31/96) and the effective date of the final regulations on ordering rules for adjustments to AAA (8/18/1998). Treas. Reg. §1.1368-4 provides a transitional rule where the S Corporation can apply a reasonable method, taking into account the statute and legislative history for the period January 1, 1997 to August 18, 1998. Thus, during this gap, either of the two ordering rules would be allowed.

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Furthermore, the ordering rules for AAA and shareholder basis are different. Thus, the auditor should review the following chapter, Shareholder Basis (S Corp 9.0), for a comparison.

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8.6 TAXABILITY OF DISTRIBUTIONS (IRC §1368(A), (B), (C))

A shareholder may report income on the distributions made by the S Corporation. The character of the income to the shareholder (ordinary income versus capital gain) will depend on the applicability of AAA in conjunction with subchapter C earnings and profits or shareholder basis. If the S Corporation has subchapter C earnings and profits, then to the extent distributions are taken from subchapter C earnings and profits, the income is ordinary and reported as dividend income on Schedule B. Distributions can be taken from subchapter C earnings and profits from the distribution ordering rules below or the S Corporation may elect with the consent of all shareholders to make distributions directly from subchapter C earnings and profits (IRC §1368(e)(3)).

However, if the S Corporation does not have subchapter C earnings and profits, then the taxability of the distribution depends on the amount of shareholder stock basis not AAA (See S Corp 9.0 - Shareholder Basis). This is the reason that the statute does not require AAA be maintained if an S Corporation does not have subchapter C earnings and profits (IRC §1368(b)). Further, the income, when the distribution is compared against shareholder stock basis, is capital because the excess of the distribution over stock basis is considered a sale or exchange of property (IRC §1368(b)(2)).

Distributions are taxable in this general order:

S Corporations With E&P

- Nontaxable to the extent AAA is positive as long as the distribution does not exceed basis.
- If stock basis is zero and AAA is still positive, then capital gain to the extent the distribution exceeds stock basis.
- If AAA is zero, dividend to the extent of subchapter C earnings & profits.

S Corporations Without E&P

- Nontaxable return of capital to extent of remaining stock basis.

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- Capital gain to the extent stock basis exceeded.

Example A
Distribution by an S Corporation with Accumulated E&P – General rule

	Distribution	AAA		Subchapter C Earnings & Profits		Stock Basis	
Balance before distribution		$30,000		$30,000		$25,000	
Distribution	100,000	25,000	(a)	30,000	(c)	-25,000	(a)
Subtotal		5,000		0		0	(d)
Capital Gain		-5,000	(b)				
Ending Balance		$0		$0		$0	

(a) Nontaxable to the extent AAA and stock basis not exceeded, $25,000.
(b) Capital gain to the extent AAA not exceeded, but stock basis exceeded, $5,000.
(c) Dividend to the extent of C corporation earnings & profits, $30,000.
(d) Nontaxable return of capital to extent of remaining stock basis, $0.
(e) Remaining balance is capital gain, $40,000 (100,000 – 25,000 - 5,000 - 30,000).

The shareholder would report the following per return:

a. Dividend, $30,000, to Schedule B.
b. Capital gain, $45,000 (5,000 + 40,000), to Schedule D.

Note
1. The $25,000 distribution from AAA is nontaxable and will not appear on the shareholder's return.
2. In most instances, stock basis is higher than AAA.

Treas. Reg. §1.1368-1(b) states that a "distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder." Therefore, AAA is adjusted in the year the S Corporation makes the distribution, regardless of when the distribution was declared by the S Corporation or the shareholder that received the distribution. Furthermore, in general, distributions made

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during the taxable year are deemed to have been made at the end of the tax year because adjustments to distributions cannot be made until after income adjustments for basis, which occurs at the end of the tax year (IRC §1367).

Example B - After 8/18/97

Distribution when there are Subchapter "C" Earnings and Profits (AE&P) and no "Net Negative Adjustment". Further, S Corporation does not make an IRC §1368(e)(3) election to distribute AE&P first.

	AAA	AE&P	Stock Basis
Beginning Balance	$200,000	$100,000	$200,000
Ordinary Income	200,000	0	200,000
Subtotal	$400,000	$100,000	$400,000
Non-taxable distribution 150,000			-150,000
IRC §1231 Loss	-150,000		-150,000
Subtotal before distribution	$250,000	$100,000	$100,000
Distribution	-150,000	0	0
End of Year Balance	$100,000	$100,000	$100,000

No part of the distribution is from AE&P.

The S Corporation could have made a "tax free" distribution from AAA of $250,000 without getting into AE&P. Refer to S Corp 9.0 - Shareholder Basis for ordering rules.

Example C - After 8/18/97 Treas. Reg. §1.1368-1(e)

Distribution by S Corporation with AE&P and a "Net Negative Adjustment". Further, S Corporation does not make an IRC §1368(e)(3) election to distribute AE&P first.

	AAA	AE&P	Stock Basis
Beginning Balance	$200,000	$100,000	$200,000
Ordinary Income	200,000	0	200,000
Subtotal	$400,000	$100,000	$400,000
IRC §1231 Loss –350,000	-200,000	0	0
Subtotal before distribution	$200,000	$100,000	$400,000

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Distribution –250,000	-200,000	-50,000	-200,000
Subtotal	$ 0	$ 50,000	$200,000
Net negative adjustment	-150,000	0	0
IRC §1231 Loss	0	0	-200,000
End of Year Balance	$-150,000	$ 50,000	$ 0

The taxpayer has suspended losses of $150,000.
$50,000 of the distribution is from AE&P, which is subject to dividend income to the shareholder.
Refer to S Corp 9.0 - Shareholder Basis for ordering rules.

Example D - After 8/18/97

Distribution by S Corporation without AE&P.

	AAA	Stock Basis	Loss Suspended
Beginning Balance	$100,000	$ 10,000	
Ordinary Income	50,000	50,000	
Subtotal before distribution	$150,000	$ 60,000	
Distribution	-40,000	-40,000	
Subtotal	$110,000	$ 20,000	
IRC §1231 Loss	-30,000	(20,000)	$(10,000)
End of Year Balance	$80,000	$ 0	$(10,000)

Refer to S Corp 9.0 - Shareholder Basis for ordering rules.

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8.7 DISTRIBUTION WHICH BYPASS AAA (IRC §1368(E)(3), R&TC §23811(E))

The most favorable distribution to an S Corporation shareholder is a nontaxable distribution from AAA. However, there are certain situations when taxable distributions from subchapter C earnings and profits are more desirable. Thus, the S Corporation with the consent of all shareholders makes IRC §1368(e)(3) elections to distribute out of subchapter C earnings and profits.

- The corporation is vulnerable to involuntary termination of its S election due to excess passive investment income (IRC §1362(d)(3)). The threat of termination applies only if the S Corporation has excess passive investment income at the end of the third consecutive year. (See S Corp 7.0 - Excess Net Passive Income Tax).
- The corporation is subject to excess net passive income tax (IRC §1375, R&TC §23811). The tax applies only if the corporation has subchapter C earnings and profits.
- The shareholder has losses on the Personal Income Tax (PIT) return that can be utilized if offset by income.
- The shareholder has investment interest expenses that cannot be deducted unless the shareholder reports investment income, etc.

IRC §1368(e)(3) provides that a corporation may make an election to distribute subchapter C earnings and profits before AAA on the return. The election has to be made and attached to the return (refer to the Federal Package X or California Form 100S Instructions). (Treas. Reg. §1.1368-1(f)) There are three methods in which to make the election.

Election to distribute subchapter C earnings and profits first:

The corporation can make an actual distribution from subchapter C earnings and profits first and issue a 1099-DIV to each shareholder. The shareholders report the taxable dividends on their individual returns.

Election to make a deemed dividend distribution:

A deemed dividend distribution is treated as if it were a pro rata distribution of money to the shareholders, received by the shareholders, and

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immediately contributed back to the corporation all on the last day of the income year.

Election to forgo Previously Taxed Income (PTI):

This is a federal provision for tax years prior to the Subchapter S Reform Act of 1982, therefore, does not apply for California purposes.

Any election stated above is irrevocable and applies only for the tax year for which the election was made. The S Corporation must attach the election statement to the original or amended return and all affected shareholders must consent to the election.

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8.8 OTHER ADJUSTMENTS ACCOUNT AND SCHEDULE M-2

The Other Adjustment Account (OAA) is used as a reconciliation account. The OAA is used to determine basis where nontaxable events have occurred. Tax-exempt income and expenses are the most common items contained in the OAA. These items increase basis but not AAA, with the exception of tax-exempt interest income pursuant to the Heller vs. Franchise Tax Board decision.

Schedule M-2 (AAA) is an important area to check when scoping the S Corporation return. Reporting trends have identified that corporations do not properly account for taxable vs. nontaxable distributions on this schedule. During scoping, compare Schedule M-2 distributions with those reported on Schedules K and K-1 to determine, with more confidence, the taxable and nontaxable portions of the distribution. In the Federal Package X, Form 1120S, Schedule M-2, Column (b) and the related instructions is the only reference to the OAA. It is not mentioned in Subchapter S or the regulations promulgated under Subchapter S.

Request copies of the S Corporation’s AAA schedules if not provided on the tax return. Compare these schedules with those computed per audit. Any material discrepancies should be discussed with the taxpayer.

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8.9 MISCELLANEOUS ITEMS

The AAA is a corporate-level account. If a shareholder disposes of his shares to another shareholder, the succeeding shareholder can receive a distribution out of the prior AAA balance, even though the succeeding shareholder may not have reported any distributive share income that generated prior AAA balance. This is different from basis whereby basis attaches to the shareholder. When a shareholder disposes of his shares, the succeeding shareholder cannot carry over the prior shareholder's basis. Instead, the succeeding shareholder's basis is his cost in acquiring the stock.

Cash distributions during the post-termination transition period are nontaxable to the extent of the ending balance of AAA (but limited to the shareholder's stock basis). The post-termination transition period generally begins on the day after the corporation's last day of S status and ends on the later of (1) one year after such last day or (2) the due date (including extensions) of that year's tax return. (IRC §1371(e)(1)).

The regulations under IRC §1368 also provide a new election to split the tax year in two in case of a "substantial stock disposition." If a shareholder disposes of 20% or more of the corporation's issued stock in one or more transactions with any 30 day period during the corporation's tax year, the corporation can elect to treat the tax year as if it consists of separate years (for purposes of allocating income and loss, adjusting AAA, basis, and subchapter C earnings and profits, and determining the taxability of distributions). (Treas. Reg. §1.1368-1(g)(1)).

If an S Corporation is not paying a "reasonable" salary to a shareholder-employee, distributions to that shareholder may be recharacterized as wages subject to payroll taxes. (Treas. Reg. §1.1361-1(l)(2)(vi)). Disproportionate distributions, constructively or actually made, may result in a deemed second class of S Corporation stock if the distributions are designed to defeat the one class of stock rule. (Treas. Reg. §1.1361-1(l)(2)(i))

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8.10 EXHIBIT

Exhibit 8.1	A checklist of the items affecting stock basis and the AAA. Adjustments to basis, AAA, and subchapter C earnings and profits during the Post-Termination Transition Period.

Exhibit 8.1

ITEMS AFFECTING STOCK BASIS AND AAA

The following is a checklist of items that affect stock basis and the accumulated adjustments account (AAA).

Increased by:	**Stock Basis**	**AAA**
Nonseparately stated items of income	Yes	Yes
Separately stated items of income	Yes	Yes
Tax-exempt income	Yes	No
COD income – On or before 12/31/02 (Gitlitz v. Comm. 2001 531 US 206)	Yes	No
COD income – After 12/31/02	No	No
The excess of the deduction for depletion over the basis in the property subject to depletion, unless the property is oil & gas property	Yes	Yes
Capital contributions	Yes	No
Decreased by:		
Nonseparately stated items of loss	Yes	Yes
Separately stated items of loss	Yes	Yes
Deductions relating to tax-exempt income	Yes	No
Corporate expenses that are neither deductible nor capitalizable	Yes	Yes
The amount of the shareholder's deduction for depletion with respect to oil and gas property to the extent such depletion does not exceed the shareholder's proportionate share of the corporation's basis in the property	Yes	Yes
Distributions	Yes [1]	Yes [2]
Negative balance permitted:	No	Yes

1 – Distributions cannot decrease basis below zero. The excess distributions are then taxable under IRC §1368.

2 – Distributions cannot decrease AAA below zero. If the corporation has C-Corporation E&P, the excess will be treated as dividend income.

ADJUSTMENTS TO BASIS, AAA, AND AE&P DURING THE POST-TERMINATION TRANSITION PERIOD

Shareholder basis and corporate-level S-Corporation accounts are adjusted during the post-termination transition period (PTTP), and are accounted for at the end of the PTTP, in the following manner:

Item	Is Adjusted During the PTTP as Follows	And at the Conclusion of the PTTP is:
Stock Basis	• Is increased by the amount of cash or property contributed to the corporation during the PTTP. • Is decreased by losses suspended as of the last day of S status due to lack of basis that are passed through to the shareholders during the PTTP. • Is decreased by losses suspended as of the last day of S status due to lack of basis that are passed through to the shareholders during the PTTP. • Is decreased by non-dividend distributions during the PTTP. • Is NOT increased by income earned or realized during the PTTP • Is NOT decreased by losses or deduction realized during the PTTP.	Carried over and becomes the shareholder's basis in the C corporation stock.
Debt Basis	• Is NOT increased by income earned or realized during the PTTP. • Is NOT decreased by losses or deductions realized during the debt owned by the PTTP.	Carried over and becomes the shareholder's basis in C corporation.
Accumulated Adjustments Account (AAA)	• Cannot increase during the PTTP. • Is decreased by non-dividend distributions during the PTTP.	Looses its identity as AAA and therefore loses its tax-free attributes. Is carried over as part of the C corporation's retained earnings.
Accumulated Earnings & Profits (AE&P)	Is increased by income earned or realized during the PTTP. Is decreased by losses and deductions realized during the PTTP. Is decreased by dividend distributions during the PTTP.	Carried over and becomes part of the C corporation's AE&P.