**8793. How are S corporation distributions taxed?**

Generally, earnings of an S corporation are not treated as earnings and profits. However, an S corporation may have accumulated earnings and profits for any year in which a valid election was not in effect or as the result of a corporate acquisition in which there is a carryover of earnings and profits under IRC Section 381.[[1]](#footnote-1) Corporations that were S corporations before 1983 but were not S corporations in the first tax year after 1996 are able to eliminate earnings and profits that were accumulated before 1983 in their first tax year beginning after May 25, 2007.[[2]](#footnote-2)

A distribution from an S corporation that does not have accumulated earnings and profits lowers the shareholder’s basis in the corporation’s stock.[[3]](#footnote-3) Any excess is generally treated as gain.[[4]](#footnote-4)

If the S corporation does have earnings and profits, distributions are treated as distributions by a corporation without earnings and profits, to the extent of the shareholder’s share of an accumulated adjustment account (i.e., post-1982 gross receipts less deductible expenses, which have not been distributed).

Any excess distribution is treated under the usual corporate rules. That is, the distribution is treated as a dividend up to the amount of the accumulated earnings and profits. Any excess is applied to reduce the shareholder’s basis. Finally, any remainder is treated as a gain.[[5]](#footnote-5) However, in any tax year, shareholders receiving the distribution may, if all agree, elect to have all distributions in the year treated first as dividends to the extent of earnings and profits and then as return of investment to the extent of adjusted basis and any excess as capital gain.[[6]](#footnote-6) If the IRC Section 1368(e)(3) election is made, it will apply to all distributions made in the tax year.[[7]](#footnote-7)

Certain distributions from an S corporation in redemption of stock are treated as a sale or exchange. Generally, only gain or loss, if any, is recognized in a sale. In general, redemptions that qualify for “exchange” treatment include redemptions that are not essentially equivalent to a dividend, substantially disproportionate redemptions of stock, complete redemptions of stock, certain partial liquidations, and redemptions of stock to pay estate taxes.[[8]](#footnote-8)

If the S corporation distributes appreciated property to a shareholder, gain will be recognized by the corporation as if the property had been sold at fair market value, and the gain will pass through to shareholders like any other gain.[[9]](#footnote-9)

1. . IRC Sec. 1371(c). [↑](#footnote-ref-1)
2. . SBWOTA 2007 Sec. 8235. [↑](#footnote-ref-2)
3. . IRC Sec. 1367(a)(2)(A). [↑](#footnote-ref-3)
4. . IRC Sec. 1368(b). [↑](#footnote-ref-4)
5. . IRC Sec. 1368(c). [↑](#footnote-ref-5)
6. . IRC Sec. 1368(e)(3). [↑](#footnote-ref-6)
7. . Let. Rul. 8935013. [↑](#footnote-ref-7)
8. . See IRC Secs. 302, 303. [↑](#footnote-ref-8)
9. . IRC Secs. 1371(a), 311(b). [↑](#footnote-ref-9)