Williams v. Commissioner, T. C. Memo. 1997-401

Adjustments to an S corporation's Accumulated Adjustments Account (AAA) for losses must be made before adjustments for shareholder distributions.

Summary

Williams v. Commissioner addresses the order of adjustments to an S corporation's AAA. The Tax Court held that losses incurred during the tax year must reduce the AAA before considering the tax treatment of shareholder distributions. Steven R. Williams, the sole shareholder of Maverick Transportation, Inc. , an S corporation, received distributions in 1990. The court ruled that these distributions were taxable to the extent they exceeded the AAA after accounting for the year's losses, in line with the legislative intent and historical application of S corporation tax rules.

Facts

Steven R. Williams was the president and sole shareholder of Maverick Transportation, Inc. (MTI), a trucking company that elected to be taxed as an S corporation in 1988. In 1990, MTI had an AAA balance of $349,256 at the start of the year. During that year, MTI incurred an ordinary loss of $217,341 and made distributions to Williams totaling $323,399. The controversy centered on whether the distributions should be taxed as dividends to the extent they exceeded the AAA after accounting for the year's loss.

Procedural History

The Commissioner determined deficiencies in Williams' Federal income tax and an accuracy-related penalty for 1990 and 1991. After concessions, the issue narrowed to the tax treatment of the 1990 distributions from MTI. The case was brought before the United States Tax Court, where Williams argued for the distributions to be considered before the annual loss, while the Commissioner argued the reverse. The Tax Court sustained the Commissioner's determination.

Issue(s)

1. Whether adjustments to an S corporation's AAA for losses incurred during the taxable year must be made prior to adjustments for shareholder distributions made during that year?

Holding

1. Yes, because the legislative history and statutory framework of sections 1367 and 1368 clearly indicate that losses must be accounted for before considering the tax treatment of shareholder distributions.

Court's Reasoning

The court's decision hinged on the interpretation of sections 1367 and 1368 of the Internal Revenue Code, which govern adjustments to S corporation shareholders' stock basis and the AAA. The legislative history of these sections, including House and Senate reports, explicitly stated that adjustments for losses should be made before adjustments for distributions. The court cited the legislative intent to align S corporation rules generally with partnership rules, yet noted the specific requirement for S corporations to account for losses first. The court also referenced subsequent regulations and a 1996 amendment to the Code, which, though not applicable to the case at hand, confirmed the existing law's requirement for loss adjustments to precede distribution adjustments. The court rejected Williams' argument that the AAA should be adjusted for distributions before losses, citing the clear legislative directive to the contrary.

Practical Implications

This decision clarifies the order of adjustments to the AAA for S corporations, impacting how tax professionals and shareholders should analyze and report distributions. Practitioners must now ensure that losses are accounted for in the AAA before considering the tax treatment of any distributions made during the year. This ruling affects the planning of distributions from S corporations, especially those with prior C corporation earnings and profits. It also highlights the importance of understanding legislative history and the statutory framework when dealing with S corporation tax issues. Subsequent cases have followed this precedent, and the 1996 amendment to section 1368 reflects a legislative acknowledgment of the existing law, albeit changing it for future years.