



Closing the Open Door—S Corporation Debt
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Open Account Debt

Halloween is just around the corner, and the IRS has given us a bit of a horror show for some S corporation clients by finalizing the open account debt proposed regulations for S Corporations. We've known since last year that the IRS was proposing to make significant changes to these regulations in light of their unhappiness with the Tax Court's decision in the case of *Brooks v. Commissioner*, TC Memo 2005-204, a case we discussed on the September 2, 2005 edition of this podcast. (If you want to listen to that podcast as a backdrop this one, the link is http://ezollars.libsyn.com/index.php?post_id=19354&comments=on)

The IRS did make some changes in the final regulations to make the provisions less onerous than originally proposed, but the final result is still one that may result in significantly different tax results for our taxpayers this year.

S Corporation Debt

S Corporations are subject to special rules due to their unique nature regarding basis. Loans from a shareholder to the S Corporation can be used to allow shareholders to deduct losses in excess of their basis in the S Corporation stock, but when that is done the basis of the debt is reduced. If that debt is repaid when the loan has reduced basis, a gain is a triggered—a gain that is capital if the loan is evidenced by a note (see Revenue Ruling 64-162) and ordinary if there is no note (Revenue Ruling 68-537).

A special category of debt is “open account” debt, as defined in Reg. §1.1367-2(a)(2). That debt is special since, as noted in the *Brooks* podcast noted above, we net all advances and repayments during the year before determining if there has been a repayment of debt. That means a shareholder could take a partial repayment on the open account early in a year when basis is below face. If it turns out that, at year end, there is not sufficient income to restore basis in the note (basis gets first restored to the note, and all accounting is done at year end), the taxpayer could advance back an amount at least equal to that repayment and not trigger the gain.

For other types of debt, we don't net repayments and advances, which means you can't dodge the gain by later loaning back funds to the corporation if the income is not high enough.

As you'll discover if you review that old podcast, Brooks took this to rather extreme levels, having loaned the entity money just before year end to claim a loss, getting repaid early the next year, and then restoring the balance just before year end—the numbers exceeded \$2 million eventually.

IRS Responds

The Tax Court found that Brooks had not abused the open account debt rules, much to the IRS's chagrin. On April 12, 2007 the IRS released proposed regulations to greatly reduce the availability of open account debt. Under the proposed regulations, open account debt would have been subjected to the following restrictions:

- Open account debt would continue to have been debt not subject to a written note, but only if such account never exceeded a \$10,000 balance during the year.
- If the debt exceeded \$10,000, that debt would now be treated as a distinct debt, and any future advances would start a new open account debt until that debt exceeded \$10,000

By doing this, the IRS would block taxpayers like the Brooks from being able to restore debt basis at year end unless such activity remained at relatively low levels. The IRS modeled that limit after the limitation found in §7872(c)(3), believing it made sense to unify the “trigger” levels.

Commentators quickly latched onto this relatively low level and the need to maintain a

daily balance for the loan. In the preamble to the final regulations, the IRS notes:

Commentators suggested that the proposed regulations' aggregate principal threshold of \$10,000 was too low for most businesses. One commentator asserted that establishing any aggregate principal threshold dollar amount for open account debt in final regulations would be arbitrary and would impose a certain compliance burden on smaller businesses. However, that commentator also suggested that increasing the aggregate principal threshold dollar amount would mitigate the compliance burden. The commentators suggested that if the final regulations adopt any threshold dollar amount for open account debt, such a threshold amount should be increased to an amount ranging from \$100,000 to \$1 million.

The IRS goes on to note comments about the daily monitoring requirement and the burden it imposed:

The proposed regulations effectively required day-to-day monitoring of open account debt. For purposes of determining compliance with the aggregate principal threshold amount for open account debt, the shareholder was required to maintain a daily running balance of shareholder advances and repayments on such advances, and the outstanding principal amount of the open account debt. Some of the commentators suggested that the daily monitoring requirement would impose an unreasonable burden on shareholders and recommended that the running balance requirement be tested quarterly, annually or when the corporation maintains and updates its other books and records. One commentator described the practice by many closely held corporations of reconciling and accounting only once a year and noted that only then would such an S corporation and its shareholder(s) know what payments are legitimately charged to the corporation as opposed to those appropriately charged to the shareholder(s).

Another commentator suggested that with daily monitoring, a maximum threshold rule for open account debt is too harsh for shareholders insofar as it immediately changes the treatment of such debt the principal balance of which exceeds the threshold by a single cent on any day, resulting in a "cliff" effect. The commentator suggested that in order to mitigate this "cliff" effect, the final regulations should adopt a second prong to the aggregate principal threshold amount test so that advances would fail to meet the definition of open account debt only if both the aggregate principal of the running balance exceeded the applicable aggregate principal threshold dollar amount on any given day of the year and the balance at the end of the year exceeded the average of the daily balances throughout the year. The commentator provided examples of intended

beneficiaries of such an "averaging" rule, for example, shareholders who need to advance their S corporation more funds on a short-time basis but end the year with an outstanding principal amount of the open account debt below the threshold level.

The IRS, after considering those comments, issued the final regulations. These regulations have an effective date of October 20, 2008, meaning that they apply right now (as the IRS had told us they planned to do when they issued the proposed regulations).

Final Regulations

The final regulations give us the following basic definition of open account debt in new Reg. §1.1367-2(a)(2)

(2) Open Account Debt --(i) General rule. The term open account debt means shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed \$25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year. Advances and repayments on open account debt are treated as a single indebtedness.

If that magic \$25,000 limit is triggered, the IRS goes on to tell us how we are to handle that condition:

(ii) Exception. If the shareholder advances not evidenced by a separate written instrument, net of repayments, exceeds an aggregate outstanding principal amount of \$25,000 at the close of the S corporation's taxable year, for any subsequent taxable year the aggregate principal amount of that indebtedness is treated in the same manner as indebtedness evidenced by a separate written instrument for purposes of this section. For any subsequent taxable year, that indebtedness is not open account debt and is subject to all basis adjustment rules applicable to basis of indebtedness of an S corporation to as shareholder in this section.

Key changes from the proposed regulations are that:

- The trigger level rises from \$10,000 to \$25,000—a minor change, but better than nothing. Still, many clients likely will run into this ceiling on open account debt.
- Rather than a daily measurement, the measurement now takes place at the end of each year, assuming the debt is not paid off during the year. Thus, clients can make short term advances to the S Corporation to meet cash flow difficulties during the year, so long as they repay enough of the debt prior to year end to get the balance below \$25,000 (presuming we started out below that level).

The IRS obviously didn't go as far as many had asked, especially on the dollar limit. The IRS explains their actions as follows in the preamble to the regulations. On the issue of the dollar limit, the IRS notes:

After considering the comments on the aggregate principal threshold dollar amount, and on recognizing customary business practices as noted by the commentators, the Treasury Department and the IRS have concluded that the aggregate principal threshold dollar amount for open account debt should be increased and that other changes are necessary. Therefore, the final regulations adopt a \$25,000 aggregate principal threshold amount per shareholder for open account debt. For example, an S corporation with ten shareholders could receive up to \$250,000 of open account debt as long as no single shareholder advanced more than \$25,000. The Treasury Department and the IRS believe that the \$25,000 threshold, together with certain other changes noted below, balances concerns over deferral potential with normal business practices. Under the final regulations, for any particular shareholder advances and repayments on those advances for which, as of the specified determination date, the aggregate principal balance exceeds the \$25,000 aggregate principal threshold amount will no longer constitute open account debt, but instead will be treated as debt evidenced by a separate written instrument subject to the basis adjustment and repayment accounting rules applicable to S corporation shareholder debt generally.

More useful is the IRS revision to an annual rather than daily monitoring of the debt balance. The IRS explains their rationale on this point as follows:

After careful consideration of these comments, the Treasury Department and the IRS have concluded that extending the period for which a shareholder determines whether shareholder advances and repayments exceed the aggregate principal threshold dollar amount for open account debt would reduce both the complexity of the regulations and any perceived burden on shareholders in making such determinations. In addition, such a modified rule should alleviate concerns over any potential "cliff" effect resulting from a day-to-day determination of threshold amount as required in the proposed regulations. The Treasury Department and the IRS also recognize that shareholder advances made to an S corporation and subsequently repaid during the same taxable year of the S corporation are not available for inclusion in the shareholder's basis in the indebtedness for purposes of passing through additional losses to the shareholder at the end of the taxable year.

Therefore, the final regulations do not adopt a daily determination of whether shareholder advances and repayments on the advances exceed the \$25,000 threshold amount. Instead, the final regulations provide that a determination of whether the threshold balance of \$25,000 is exceeded will be

made at the end of the taxable year of the S corporation. Under these final regulations, however, if open account debt is disposed of in whole or in part before the end of the S corporation's taxable year, the determination of whether the advances and repayments have exceeded the designated aggregate principal threshold amount must be made immediately before the disposition of the debt during that taxable year. Moreover, if a shareholder with open account debt is no longer a shareholder at the end of the S corporation's taxable year, the determination must be made immediately before the shareholder's interest in the S corporation is terminated.

Effective Date Issues

The introduction of this new system causes issues with existing debt, and the IRS does provide that old debt doesn't have to be analyzed under these rules—but they do not provide that you can continue to make advances on such old open account debt, as future advances will be tested under the new rules.

The preamble notes a confusion over the matter existed for at least one commentator on the proposed regulations

One of the commentators believed that the effective date language in the proposed regulations was subject to two interpretations. Under the first interpretation, the rules under these final regulations (New Rules) would apply only to open account debt created on or after the effective date, that is, shareholder advances made on or after the effective date and repayments on those same advances. The rules under the prior final regulations (as contained in the 26 CFR edition revised April 1, 2007) (Old Rules) would apply to open account debt created before the effective date, that is, shareholder advances with respect to pre-effective date open account debt and repayments on those prior advances. Accordingly, a shareholder could have open account debt, subject to the Old Rules, and open account debt, subject to the New Rules, to which new shareholder advances and repayments on those advances could be made after the effective date.

Under the second interpretation, a shareholder could not make additional advances with respect to open account debt created before the effective date but could receive repayments on that debt under the Old Rules. Accordingly, the New Rules would apply to all shareholder advances on and after the effective date, as well as repayments on those advances, and the Old Rules would apply only to repayments on pre-effective date open account debt.

The Treasury and IRS go on to clarify they mean that the second interpretation should apply, noting:

The Treasury Department and the IRS intend that the rules under these final regulations (New Rules) apply to any and all shareholder advances made on and after the effective date. The rules under these final regulations (New Rules) also apply to repayments on such advances. However, if a shareholder has open account debt (net of prior repayments in the taxable year) outstanding prior to the effective date of these final regulations, the rules under the prior final regulations (Old Rules) apply to any repayments on such pre-effective date open account debt. Accordingly, that pre-effective date open account debt will not be subject to any aggregate principal threshold dollar amount. The shareholder may not make additional advances with respect to the pre-effective date open account debt (because all shareholder advances made on or after the effective date of these final regulations constitute new open account debt subject to these final regulations).

The IRS goes on to offer an example to explain the application of the default effective date rules:

For instance, assume that the effective date of these final regulations falls within the taxable year of shareholder A's S corporation. Also assume that, at the beginning of the S corporation's taxable year, A will have existing open account debt with an outstanding principal balance of \$12,000. Assume further that A will make an additional advance of \$3,000 to and will receive a \$2,000 repayment from his S corporation prior to the effective date. Thus, as of the effective date, A will have existing open account debt with an outstanding principal balance of \$13,000 (A would net the pre-effective date advance and repayment for the taxable year and combine that net advance of \$1,000 with the \$12,000 outstanding aggregate principal balance of the then existing open account debt). This \$13,000 pre-effective date open account debt would not be subject to these final regulations and, thus, would not be subject to any aggregate principal threshold dollar amount and would be repaid under the rules of the prior final regulations. If, on or after the effective date of these final regulations, A were to both make an advance of \$5,000 to his S corporation and receive a \$1,000 repayment on that advance, the advance and repayment would constitute separate new open account debt subject to the rules under these final regulations.

Note that if the \$1,000 was treated as a repayment of the original loan and that loan had its basis reduced in the prior year end, a gain would be triggered unless income was high enough to restore the debt basis at year end.

The IRS also notes that taxpayers have the option to bring that old debt under the new rules instead, which in the above case would eliminate the two debts:

Shareholders also have the option to apply these rules to shareholder advances to the S corporation and repayments on those advances by the S corporation made before the effective date of these regulations. Using the example above, A would have the option to net the \$5,000 advance and \$1,000 repayment.

In this case, there would be an overall net increase in the open account debt, eliminating the exposure to a partial repayment of the debt. However, taxpayers will need to look at the overall issues related to treating old debt under the new rules when making their choice.

One More Thing...

The IRS also telegraphs that the whole issue of the tax treatment of debt repayments may be something they want to look at, though not dealing with it right now, noting:

One of the commentators suggested that the final regulations address the issue of how to characterize any income or gain that is recognized upon repayment of both open account debt and indebtedness evidenced by a written instrument. While recognizing the commentators' concerns, the Treasury Department and the IRS believe that the characterization issue is beyond the scope of these final regulations. However, the Treasury Department and the IRS intend to continue considering the characterization issue.

Action Points

Year end planning is coming upon us, and this new regulation will eliminate one of the flexibility options many clients may have been relying upon to avoid paying tax on repayments and being able to claim their entire loss. Clients will need to be counseled about the issues that now will arise with repayment of any debt that has a balance in excess of \$25,000 at the end of the year if that debt has its basis reduced, noting that if there is not sufficient income in the coming year to restore that lost basis, that a gain will be triggered by the repayment—and loaning more money back to the S Corporation won't solve the issue.

Similarly, if clients often loan the corporation money to meet temporary cash flow issues, care will need to be taken to insure that the balance at any year end is not greater than \$25,000.

All of these issues suggest that it may be prudent to review the files for any S Corporation client to see if they might be impacted by these rules, and consider contacting the client prior to year to see what steps might make sense to take in their situation.