



**Intermediate 1120S
Solving S Corp Problems**

Handout

June 2011

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Loans to Shareholders

The issue is a “loan” may be recharacterized as wages under audit, subject to payroll tax, penalties and interest.

Here’s what sorts of bad things can happen under recharacterization:

	Employer A (Correctly classifies payment as wages)	Employer B (Misclassifies payment as “loan”)*
UI & ETT (3.5%)	\$ 245	\$ 245
CA SDI (1.1%)		220
PIT (6%)		1,200
FUTA (6.2%)	56	434
FICA (ER 7.65%)	1,530	1,530
FICA (EE 5.65%)		1,130
FIT (25%)		5,000
Total due for 1 year	\$ 1,831	\$ 9,759

*This example is for one worker paid \$20,000 that is recharacterized as Wages, not including penalty and interest.

Elements for a “good” loan:

- 1.) Note
- 2.) Note recorded in corporate minutes
- 3.) Reasonable Interest Rate
- 4.) Payments made on note
- 5.) Cancelled checks to prove payments were made per Note.

Officer Compensation

“Reasonable Wage”

US Department of Labor, Bureau of Labor Statistics.

<http://www.bls.gov/sae/home.htm>

541200 is NAICS code for Tax Preparers (I googled this number).

Quarterly Census of Employment and Wages

Series Id: ENU06013505541213
State: California
Area: Contra Costa County, California
Industry: NAICS 541213 Tax preparation services
Owner: Private
Size: All establishment sizes
Type: Average Annual Pay
Year Annual

- 2001 34,959
- 2002 21,081
- 2003 21,017
- 2004 23,901
- 2005 29,532
- 2006 28,619
- 2007 31,258
- 2008 30,494 : Preliminary.

Series Id: ENU0601350554121
State: California
Area: Contra Costa County, California
Industry: NAICS 54121 Accounting and bookkeeping services
Owner: Private
Size: All establishment sizes
Type: Average Annual Pay

Year	Annual
2001	49015
2002	49795
2003	47169
2004	49918
2005	52078
2006	54852
2007	56759
2008	60233(P)

So it's better to be a bookkeeper than a tax preparer.

Source: <http://data.bls.gov/PDQ/outside.jsp?survey=en>

Automobile Policy

SAMPLE CORPORATE POLICY to be adopted at a Board of Director's Meeting for an Accountable Plan:

“The corporation establishes a policy of reimbursing employees for miles driven for the corporation, in an amount equal to the maximum allowable federal deduction per mile, provided the employee submits an expense report documenting the date, mileage, and the business purpose for the trip.”

Health Insurance

The rules about deducting health insurance were relaxed about 2007-08, now allows a plan in the name of the individual to be paid by the corporation (reimbursed), but greater than 2% shareholders' health benefit is not deductible to the corporation.

You'll want to include health insurance benefits as part of the officer compensation package voted on at a Board of Director's Meeting also.

Sample W-2 – The proper way to report Auto/Health

If you're reporting personal use of a corporate owned automobile, or company paid health insurance for a more than 2% shareholder, you include the value(s) in Box 1 and Box 16, and in Box 14.

The taxable benefit is included as wage in Boxes 1 and 16, but not included as wage base for Social Security nor Medicare in boxes 3 and 5. These benefits are not FICA taxable.

Include a note or notes in Box 14 as "Auto" and/or "Health" with the amounts.

These are not deductions for the corporation as either Auto or Health, the corporation deducts these expenses as wage. It becomes income to the employee, and must be reported. The shareholder may be able to deduct the amounts from their personal Form 1040. Auto use income is probably just taxable. Health insurance may be deducted as Self-Employed Health Insurance to the limit of wages.

22222		Void <input type="checkbox"/>		a Employee's social security number		For Official Use Only ▶ OMB No. 1545-0008	
b Employer identification number (EIN)				1 Wages, tips, other compensation		2 Federal income tax withheld	
c Employer's name, address, and ZIP code				3 Social security wages		4 Social security tax withheld	
				5 Medicare wages and tips		6 Medicare tax withheld	
				7 Social security tips		8 Allocated tips	
d Control number				9 Advance EIC payment		10 Dependent care benefits	
e Employee's first name and initial		Last name		Suff.		11 Nonqualified plans	
f Employee's address and ZIP code				13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12a See instructions for box 12	
				14 Other		12b	
						12c	
15 State		Employer's state ID number		16 State wages, tips, etc.		17 State income tax	
						18 Local wages, tips, etc.	
						19 Local income tax	
						20 Locality name	

Retirement plan contributions

Retirement plan contributions for sole-owner S Corporations can be somewhat confusing.

This article is ONLY about SEP's and 401(k)s for 100% owners of S Corporations with no other employees.

I don't discuss tax returns for retirement plans. I have also not included the "catch up" contribution limits for the 401(k). I'm presuming in my example the shareholder is under 50 years old.

Employees need to be considered in retirement planning, so if you have other employees or expect to have employees "someday," I'd use a professional administrator.

There are two different sources of contributions to retirement plans: Employee and Employer. Money withheld from employees through payroll is called an "Elective Deferral." These amounts are excluded from income tax, but are still subject to FICA, FUTA and SDI taxes.

Money contributed by an employer is not only excluded from the employee's income tax, but also not subject to FICA, FUTA nor SDI tax, because it is not payroll.

The limits on contributions from either source are based on W-2 income. The limits do not include the pass through amounts from the K-1, as these are not earned income. The amount on the K-1 is irrelevant for the retirement plan contribution calculation.

When the employer, the S Corporation, makes a contribution towards the shareholder's retirement plan, it is deducted at the corporate level. There is no box on the K-1 to pass through a retirement plan contribution.

That pesky 2% rule applies to fringe benefits. I guess a retirement plan is a 'mainstream benefit?' (A side note: Health Insurance IS a fringe benefit, so technically, >2% shareholder health insurance is supposed to be added to the shareholder W-2 in boxes 1 and 17, with the code "Health" and the amount in box 14. SE Health Insurance is then deducted by the shareholder on the front of their personal 1040 as they are able. Health insurance fringe benefit is not subject to FICA, etc., and not passed through on the K-1, although it sometimes appears there because we don't have control over the W-2).

SEP (Simplified Employee Pension) Contribution Deadline and Limits

Contributions to a SEP may be made up to the due date of the employer's return, including extensions, and you can set up the plan as you make the contribution.

Shareholder Elective Deferrals from the W-2 income do not exist for SEP plans for an S Corporation.

Employer limits for excludable contributions are the lesser of 25% of the shareholder's W-2 wage (sole-proprietors and partners must calculate 25% of 80%, so being a corporation allows an extra 5% contribution), or \$46,000 for 2008 (\$49,000 for 2009) (IRS Notice 2008-102)

401(k) Plan Contribution Deadline and Limits

401(k) plan company contributions are due by the due date of the employer's return including extensions (same as the SEP), but the plan must be established on or before year end (different from the SEP). Elective Deferral payments are normally due within 7 days of the payroll date.

You need to pay a professional administrator to write your 401(k) plan to make sure the plan documents allow for the maximum contributions.

Shareholder Elective Deferral contributions are limited to the lesser of 100% of employee salary or \$15,500 (\$16,500 for 2009).

Employer contributions to a shareholder 401(k) are limited to 25% of W-2 (Medicare income from box 5), with a maximum of \$46,000 (\$49,000 for 2009).

For the 401(k), the combination of employee deferrals and employer contributions is limited to \$46,000 (\$49,000 for 2009) – so if your W-2 wage is \$199,500 you can't get \$15,500 Elective Deferral plus another \$46k from the corporation.

Which is Best?

Let's run a comparison for a 100% shareholder of an S Corporation, Bob, who is 46, in 2008 with no other employees who wants to maximize his contribution to his retirement plan. Bob has W-2 wage of \$100,000 and K-1 of \$60,000 before making a retirement plan contribution. Bob wants to contribute the maximum allowable, and has set up his retirement plan with his pension administrator well in advance.

With the SEP

The rule is the corporation may contribute the lesser of 25% of W-2 wage or \$46,000, so Bob's S corporation contributes \$25,000.

Bob's W-2 shows \$100,000 for all taxes. Bob's K-1 shows \$35,000.

With the 401(k)

The rule is Elective Deferral is the lesser of 100% of W-2 wage or \$15,500, so Bob elects \$15,500. This happened before year-end, because it came out of Bob's paychecks.

Bob's W-2 box 1 and 17 taxable income is lower by \$15,500, but FICA, FUTA and SDI are still calculated at the \$100,000 wage (ok, ok \$100,000 for FICA, \$7,000 for FUTA and \$86,698 for SDI).

The rule for the corporate contribution is the lesser of 25% of W-2 wage, or \$46,000, so Bob's corporation contributes \$25,000 more.

Bob's K-1 says \$35,000.

If you plan ahead, like Bob did, the 401(k) allows more contributions, particularly at lower W-2 wage numbers because the Elective Deferral can be up to 100% of wages.

Pages 7-9 are a reprint of an article published in "California Enrolled Agent" November 2009 Issue, pages 17-19.

Charitable Contributions are not deducted by the corporation, they pass thru to the Shareholder for them to deduct to the extent allowable on their personal Schedule A.

For a charitable contribution of \$1500, for example, here's what shows up on Page 3 of the 1120S:

Form 1120S (2006) S-CORP OF JUNK 99-9999999		Page 3
Shareholders' Pro Rata Share Items (continued)		Total amount
Deductions	11 Section 179 deduction (attach Form 4562).....	11
	12a Contributions..... SEE STATEMENT 1	12a 1,500.
	b Investment interest expense.....	12b
	c Section 59(e)(2) expenditures (1) Type ▶ (2) Amount. ▶	12c (2)
	d Other deductions (see instructions).. Type ▶	12d

And on the K-1:

11	Section 179 deduction	16	Item
12	Other deductions		
A	1,500.		

Home Office

Potentially construed as disguised wages

Elements for a “good” home office:

- 1.) Rental agreement between corporation and landlord
- 2.) Reasonable Rent Charged (not a huge loss or gain)
- 3.) Cancelled Checks for Rent Paid
- 4.) 1099-Misc for Rent Paid (box 1)
- 5.) Schedule E

Speers v. Commissioner TC Memo 1994-157

Code Section 280A(a) no deduction, but exception is in Section 280A(c).

9595 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Rents		OMB No. 1545-0115	
		\$ Rent Paid		<div style="font-size: 2em; font-weight: bold;">2009</div> <div style="font-weight: bold;">Miscellaneous Income</div>	
		2 Royalties			
		\$			
		3 Other Income		4 Federal income tax withheld	
		\$		\$	
PAYER'S federal identification number	RECIPIENT'S identification number	5 Fishing boat proceeds		6 Medical and health care payments	
		\$		\$	
RECIPIENT'S name		7 Nonemployee compensation		8 Substitute payments in lieu of dividends or interest	
		\$		\$	
Street address (including apt. no.)		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>		10 Crop insurance proceeds	
		\$		\$	
City, state, and ZIP code		11		12	
Account number (see Instructions)		2nd TIN not <input type="checkbox"/>		13 Excess golden parachute payments	
				\$	
15a Section 409A deferrals		15b Section 409A income		14 Gross proceeds paid to an attorney	
\$		\$		\$	
				16 State tax withheld	
				\$	
				17 State/Payer's state no.	
				\$	
				18 State income	
				\$	

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service
Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

The Golden Rule

Income is taxed at
least

Once taxed,

Sample Section 351 Tax Free Exchange Statement

- 1.) Name and ID of company
- 2.) Date of Asset Transfer
- 3.) FMV and Basis of transferred assets
- 4.) Date of any PLR regarding transfer.

Any liabilities assumed by the corporation need to be for a business purpose, and less than the basis of the contributed property, otherwise it is relief of debt and is a taxable event. See Publication 544 for more information.

NO.	DESCRIPTION	DATE ACQUIRED	DATE SOLD	COST/ BASIS	BUS. PCT.	CUR 179/ SDA	PRIOR 179/ SDA/ DEPR.	METHOD	LIFE	CURRENT DEPR.
SCHEDULE C - SAMPLES R US										
1	COMPUTER	7/15/04		1,232			640	2000B HY	5	237
2	COMPUTER	12/31/05		679			679	2000B HY	5	0
3	AERON CHAIRS	6/15/06		800				2000B HY	7	114
TOTAL				2,711		0	1,319			351
TOTAL DEPRECIATION				2,711		0	1,319			351
GRAND TOTAL DEPRECIATION				2,711		0	1,319			351

Demo

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts
Under Sections 179 and 280F(b)(2))
▶ Attach to your tax return. ▶ See separate instructions.

Name(s) shown on return BOB AND SAMPLE	Identifying number 999-99-9999
--	--

1 Enter the gross proceeds from sales or exchanges reported to you for 2006 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft – Most Property Held More Than 1 Year (see instructions)

2	(a) Description of property	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) (Subtract (f) from the sum of (c) and (e))
	COMPUTER	7/15/04	6/15/06		759.	1,232.	-473.

3 Gain, if any, from Form 4684, line 42	3	
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6 Gain, if any, from line 32, from other than casualty or theft	6	
7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.	7	-473.
8 Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

COMPUTER	12/31/05	6/15/06	679.	679.	0.
AERON CHAIRS	6/15/06	6/15/06		800.	-800.

11 Loss, if any, from line 7	11	-473.
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	
13 Gain, if any, from line 31	13	
14 Net gain or (loss) from Form 4684, lines 34 and 41a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17 Combine lines 10 through 16	17	-1,273.
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below: a If the loss on line 11 includes a loss from Form 4684, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from 'Form 4797, line 18a.' See instructions	18a	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	-1,273.

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

2006

Department of the Treasury
Internal Revenue Service (99)

▶ Attach to your tax return. ▶ See separate instructions.

Attachment
Sequence No. **27**

Name(s) shown on return

Identifying number

BOB AND SAMPLE

999-99-9999

1 Enter the gross proceeds from sales or exchanges reported to you for 2006 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft – Most Property Held More Than 1 Year (see instructions)

2	(a) Description of property	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	COMPUTER	7/15/04	6/15/06	473.	759.	1,232.	0.

- 3 Gain, if any, from Form 4684, line 42 **3**
- 4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 **4**
- 5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 **5**
- 6 Gain, if any, from line 32, from other than casualty or theft **6**
- 7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: **7**
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.
- Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.
- 8 Nonrecaptured net section 1231 losses from prior years (see instructions) **8**
- 9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 2 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions) **9**

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

COMPUTER	12/31/05	6/15/06		679.	679.	0.
AERON CHAIRS	6/15/06	6/15/06	800.		800.	0.

- 11 Loss, if any, from line 7 **11**
- 12 Gain, if any, from line 7 or amount from line 8, if applicable **12**
- 13 Gain, if any, from line 31 **13**
- 14 Net gain or (loss) from Form 4684, lines 34 and 41a **14**
- 15 Ordinary gain from installment sales from Form 6252, line 25 or 36 **15**
- 16 Ordinary gain or (loss) from like-kind exchanges from Form 8824 **16**
- 17 Combine lines 10 through 16 **17**
- 18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:
 - a If the loss on line 11 includes a loss from Form 4684, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from 'Form 4797, line 18a.' See instructions **18a**
 - b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14 **18b**

BAA For Paperwork Reduction Act Notice, see separate instructions.

CLIENT 166

BOB AND SAMPLE

999-99-9999

10/22/07

08:38AM

NO.	DESCRIPTION	DATE ACQUIRED	DATE SOLD	COST/ BASIS	BUS. PCT	CUR 179/ SDA	PRIOR 179/ SDA/ DEPR	METHOD	LIFE	CURRENT DEPR
SCHEDULE C - SAMPLES R US										
1	COMPUTER	7/15/04	6/15/06	1,232			640	200DB HY	5	119
2	COMPUTER	12/31/05	6/15/06	679			679	200DB HY	5	0
3	AERON CHAIRS	6/15/06	6/15/06	800				200DB HY	7	0
TOTAL				2,711		0	1,319			119
TOTAL DEPRECIATION				2,711		0	1,319			119
GRAND TOTAL DEPRECIATION				2,711		0	1,319			119
DEPRECIATION ASSETS SOLD				2,711		0	1,319			119
DEPR REMAINING ASSETS				0		0	0			0

Demo

Transferors' Code Section 351 Disclosure Statement

Name: Bob Sample

TIN: 999-99-9999

Tax Year: 2006

Taxpayer submits the following statement pursuant to the requirements of Reg 1.351-3(a):

On 6/15/06 the taxpayer transferred the property listed below to:

Name of Corporation: S-Corp of Junk

TIN: 99-9999999

Address: 1442 A Walnut St #365
Berkeley CA 94709

1. Description of Property Transferred

Property	Tax Basis at Date of Transfer	FMV
-----	-----	---
Computer 04	\$473	\$200
Computer 05	\$0	\$300
Aeron Chairs	\$800	\$800
Cash	\$2,000	\$2,000

2. Transferors' liabilities assumed by the corporation on the exchange:

Amount and Description	When and under what circumstances as created	Business Reason for assumption
-----	-----	-----
\$432 Note against Computer 05	Purchase 12/31/05	Attaches to property

Beginning Balance Sheet

ASSETS	
Current Assets	
Checking/Savings	
Bank Account	2,000.00
Total Checking/Savings	<u>2,000.00</u>
Total Current Assets	2,000.00
Fixed Assets	
Computers and Machinery	473.00
Furniture and Fixtures	800.00
Total Fixed Assets	<u>1,273.00</u>
Other Assets	
Start Up Costs	699.00
Total Other Assets	<u>699.00</u>
TOTAL ASSETS	<u><u>3,972.00</u></u>
LIABILITIES & EQUITY	
Liabilities	
Current Liabilities	
Other Current Liabilities	
Note Payable-Computer	432.00
Total Other Current Liabilities	<u>432.00</u>
Total Current Liabilities	<u>432.00</u>
Total Liabilities	432.00
Equity	
Capital Stock	3,540.00
Total Equity	<u>3,540.00</u>
TOTAL LIABILITIES & EQUITY	<u><u>3,972.00</u></u>

<- Calculated

Ending Balance Sheet 1120S

Description	Date	Cost	Salvage	Business percentage	Section 179	Depreciation Basis	Life	Method	Rate	Current depr.
Computer 04	20080615	473		100.00		473	5	200 DB HY	20	95
Aeron Chairs	20080615	800		100.00		800	7	200 DB HY	14.29	114
Startup Costs	20080615	699		100.00		699	15	195	3.8889	699

Not Eligible for Special Depreciation – Used Assets!

Ending Balance Sheet

Schedule L	Balance Sheets per Books	Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				2,000
2 a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10 a	Buildings and other depreciable assets			1,273	
b	Less accumulated depreciation	()		(209)	1,064
11 a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13 a	Intangible assets (amortizable only)			699	
b	Less accumulated amortization	()		(699)	
14	Other assets (attach statement)				
15	Total assets				3,064
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				432
18	Other current liabilities (attach statement)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock				3,540
23	Additional paid-in capital				
24	Retained earnings				(908)
25	Adjustments to shareholders' equity (attach statement)				
26	Less cost of treasury stock	()		()	
27	Total liabilities and shareholders' equity				3,064

Schedule M-1

Ties Tax Return to Books. Accounting income vs. Tax income.

Schedule M-1		Reconciliation of Income (Loss) per Books With Income (Loss) per Return	
<small>Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more-see instructions</small>			
1	Net income (loss) per books	(908)	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize): _____		5 Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize): a Tax-exempt interest \$ _____
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14I (itemize): a Depreciation \$ _____ b Travel and entertainment \$ _____		6 Deductions included on Schedule K, lines 1 through 12 and 14I, not charged against book income this year (itemize): a Depreciation \$ _____
4	Add lines 1 through 3	(908)	7 Add lines 5 and 6
			8 Income (loss) (Schedule K, line 18). Line 4 less line 7
			(908)

Schedule M-2

Schedule M-2 holds the “undistributed” income or loss that may affect future tax consequences for the corporation.

Losses are different from distributions.

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)			
	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year			
2 Ordinary income from page 1, line 21			
3 Other additions			
4 Loss from page 1, line 21	(908)		
5 Other reductions	()	()	
6 Combine lines 1 through 5	(908)		
7 Distributions other than dividend distributions -			
8 Balance at end of tax year. Subtract line 7 from line 6 -	(908)		

Bob has taken the “reserve money” under the tray in the register—he’s taken a loss against his contribution for stock in our example.

And here’s a more interesting example, where the “cash register drawer” analogy works. The Distributions are like taking money out of the register drawer at year end. It doesn’t affect taxation, except when the owner takes more money than was available—essentially “new” income to the owner.

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)			
	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1 Balance at beginning of tax year	0 .		
2 Ordinary income from page 1, line 21	39,340 .		
3 Other additions			
4 Loss from page 1, line 21			
5 Other reductions SEE STATEMENT 4	(6,335 .)		
6 Combine lines 1 through 5	33,005 .		
7 Distributions other than dividend distributions	24,000 .		
8 Balance at end of tax year. Subtract line 7 from line 6	9,005 .		

Schedule M-2, Column B is for tax exempt income—which adjusts basis.

Schedule M-2, Column C is for S corporations that were previously C Corporations – it keeps track of income that was taxed to the corporation during “C” status, but has yet to be distributed to the shareholders. If you were never a “C” corporation, this column will be blank.

BIG Tax, Built In Gains tax applies when you convert a “C” Corporation to an “S” Corporation and you have unrealized gains.

If the C Corporation has assets that have appreciated, often real estate, the tax on the gain for those assets retains its character and will be taxed at 35% if the assets are sold/disposed of.

Schedule B	Other Information (see instructions)	Yes	No
1	Check accounting method: a <input checked="" type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶ _____		
2	See the instructions and enter the: a Business activity ▶ _____ b Product or service... ▶ _____		
3	At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a statement showing: (a) name and employer identification number (EIN), (b) percentage owned, and (c) if 100% owned, was a QSub election made?.....		X
4	Was the corporation a member of a controlled group subject to the provisions of section 1561?.....		X
5	Has this corporation filed, or is it required to file, a return under section 6111 to provide information on any reportable transaction?.....		X
6	Check this box if the corporation issued publicly offered debt instruments with original issue discount..... <input type="checkbox"/> If checked, the corporation may have to file Form 8281, Information Return for Publicly Offered Original Issue Discount Instruments.		
7	If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years..... ▶ \$ 900,000.		
8	Enter the accumulated earnings and profits of the corporation at the end of the tax year..... \$ _____		
9	Are the corporation's total receipts (see instructions) for the tax year and its total assets at the end of the tax year less than \$250,000? If "Yes," the corporation is not required to complete Schedules L and M-1.....	X	

Note: If the corporation, at any time during the tax year, had assets or operated a business in a foreign country or U.S. possession, it may be required to attach Schedule N (Form 1120), Foreign Operations of U.S. Corporations, to this return. See Schedule N for details.

In our example above, we have a building with a basis of \$100,000 that appraised for \$1,000,000. GET AN APPRAISAL at conversion! You’ll need it if you sell the asset before 10 years have elapsed.

You can avoid the BIG tax using the following strategies:

- 1.) Sell something with a Built In Loss
 - 2.) 1031 Exchange the property with another
 - 3.) Wait 10 years until you sell, or if you have an income limitation.
- Use loss carryforwards against the income generated by the gain.

Here's an example of **BIG tax**, if you had an appraisal of \$1,000,000 on conversion and sold for 1,500,000. You see the tax is 35% on line 19.

SCHEDULE D (Form 1120S)		Capital Gains and Losses and Built-In Gains				OMB No. 1545-0130
Department of the Treasury Internal Revenue Service		▶ Attach to Form 1120S. ▶ See separate instructions.				2006
Name S-CORP OF JUNK					Employer identification number 99-9999999	
Part I Short-Term Capital Gains and Losses – Assets Held One Year or Less						
1	(a) Description of property (Example, 100 shares of Z Co)	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Sales price	(e) Cost or other basis (see instructions)	(f) Gain or (loss) (Subtract (e) from (d))
2	Short-term capital gain from installment sales from Form 6252, line 26 or 37.....					2
3	Short-term capital gain or (loss) from like-kind exchanges from Form 8824.....					3
4	Combine lines 1 through 3 in column (f).....					4
5	Tax on short-term capital gain included on line 21 below.....					5
6	Net short-term capital gain or (loss). Combine lines 4 and 5. Enter here and on Form 1120S, Schedule K, line 7 or 10.....					6
Part II Long-Term Capital Gains and Losses – Assets Held More Than One Year						
7	(a) Description of property (Example, 100 shares of Z Co)	(b) Date acquired (month, day, year)	(c) Date sold (month, day, year)	(d) Sales price	(e) Cost or other basis (see instructions)	(f) Gain or (loss) (Subtract (e) from (d))
	PROPERTY	1/01/72	12/31/06	1,500,000.	100,000.	1,400,000.
8	Long-term capital gain from installment sales from Form 6252, line 26 or 37.....					8
9	Long-term capital gain or (loss) from like-kind exchanges from Form 8824.....					9
10	Capital gain distributions.....					10
11	Combine lines 7 through 10 in column (f).....					11 1,400,000.
12	Tax on long-term capital gain included on line 21 below.....					12 -315,000.
13	Net long-term capital gain or (loss). Combine lines 11 and 12. Enter here and on Form 1120S, Schedule K, line 8a or 10.....					13 1,085,000.
Part III Built-In Gains Tax (See instructions before completing this part.)						
14	Excess of recognized built-in gains over recognized built-in losses (attach computation schedule)..... SEE STATEMENT 2					14 900,000.
15	Taxable income (attach computation schedule)..... SEE ATTACHED WORKSHEET					15 1,399,878.
16	Net recognized built-in gain. Enter the smallest of line 14, line 15, or line 7 of Schedule B.....					16 900,000.
17	Section 1374(b)(2) deduction.....					17
18	Subtract line 17 from line 16. If zero or less, enter -0- here and on line 21.....					18 900,000.
19	Enter 35% of line 18.....					19 315,000.
20	Section 1374(b)(3) business credit and minimum tax credit carryforwards from C corporation years.....					20
21	Tax. Subtract line 20 from line 19 (if zero or less, enter -0-). Enter here and on Form 1120S, page 1, line 22b.....					21 315,000.

BAA For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Form 1120S.

Schedule D (Form 1120S) 2006

External Basis

Aka “Skin in the game” this is what the shareholder has “invested” in the corporation that has been previously taxed, or taxed in the current year. Losses are limited to loss of previously taxed income.

Calculate this at the end of each year, and leave yourself a worksheet. This can be different from the internal basis, and is difficult to re-create without lots of time. It’s important when terminating the corporation, or selling the stock.

Shareholder Basis is increased by

- Purchase of Stock by shareholder
- Income from Corporation taxed to shareholder
- Contributions
- Qualified Loans made to the corporation (more than a ‘guarantee’—has to be cash-like)

Shareholder Basis is reduced by

- Business losses taken
- Section 179
- Non-Deductible Expenses
- Repayment of Qualified Loans
- Distributions
- Shareholder selling their stock
- Charitable contributions

LIABILITIES & EQUITY		
Liabilities		
Current Liabilities		
Credit Cards		
Credit Card	12,375.00	← Added Credit Card
Total Credit Cards	12,375.00	
Other Current Liabilities		
Note Payable-Computer	432.00	
Total Other Current Liabilities	432.00	
Total Current Liabilities	12,807.00	
Total Liabilities	12,807.00	
Equity		
Capital Stock	-8,835.00	← Not OK
Net Income	-908.00	
Total Equity	-9,743.00	
TOTAL LIABILITIES & EQUITY	3,064.00	

LIABILITIES & EQUITY		
Liabilities		
Current Liabilities		
Credit Cards		
Credit Card	12,375.00	
Total Credit Cards	12,375.00	
Other Current Liabilities		
Note Payable-Computer	432.00	
Total Other Current Liabilities	432.00	
Total Current Liabilities	12,807.00	
Total Liabilities	12,807.00	
Equity		
Capital Stock	3,540.00	← Better, but relief of debt.
Distribution	-12,375.00	
Net Income	-908.00	
Total Equity	-9,743.00	
TOTAL LIABILITIES & EQUITY	3,064.00	

ASSETS	
Current Assets	
Checking/Savings Bank Account	2,000.00
Total Checking/Savings	2,000.00
Other Current Assets	
Loan to Shareholder	12,375.00
Total Other Current Assets	12,375.00
Total Current Assets	14,375.00
Fixed Assets	
Accumulated Depreciation	-209.00
Computers and Machinery	473.00
Furniture and Fixtures	800.00
Total Fixed Assets	1,064.00
Other Assets	
Accumulated Amortization	-699.00
Start Up Costs	699.00
Total Other Assets	0.00
TOTAL ASSETS	15,439.00
LIABILITIES & EQUITY	
Liabilities	
Current Liabilities	
Credit Cards	
Credit Card	12,375.00
Total Credit Cards	12,375.00
Other Current Liabilities	
Note Payable-Computer	432.00
Total Other Current Liabilities	432.00
Total Current Liabilities	12,807.00
Total Liabilities	12,807.00
Equity	
Capital Stock	3,540.00
Net Income	-908.00
Total Equity	2,632.00
TOTAL LIABILITIES & EQUITY	15,439.00

← Best
so far.

Internal Revenue Bulletin: 2008-47
November 24, 2008

T.D. 9428

Section 1367 Regarding Open Account Debt

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DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

AGENCY:

Internal Revenue Service (IRS), Treasury.

ACTION:

Final regulations.

SUMMARY:

This document contains final regulations relating to the treatment of open account debt between S corporations and their shareholders. These final regulations provide rules regarding the definition of open account debt and the adjustments in basis of any indebtedness of an S corporation to a shareholder under section 1367(b)(2) of the Internal Revenue Code (Code) for shareholder advances and repayments on advances of open account debt. The regulations affect shareholders of S corporations and are necessary to provide guidance needed to comply with the applicable tax law.

DATES:

Effective Date: These regulations are effective on October 20, 2008.

Applicability Date: For dates of applicability, see §1.1367-3.

FOR FURTHER INFORMATION CONTACT:

Stacy L. Short or Deane M. Burke, (202) 622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends §1.1367-2 of the Income Tax Regulations (26 CFR part 1) regarding the definition of open account debt and adjustments in basis of indebtedness for shareholder advances and repayments on advances of open account debt.

Section 1367(a)(1) provides that the basis of each shareholder's stock in an S corporation is increased by the shareholder's *pro rata* share of the S corporation's income (separately and nonseparately computed items of income) and the excess of the deductions for depletion over the basis of the property subject to depletion. Section 1367(a)(2) provides that the basis of each shareholder's stock in the S corporation is decreased by the shareholder's distributions not includible in income of the shareholder by reason of section 1368 (nontaxable distributions), and the shareholder's *pro rata* share of the losses and deductions (separately and nonseparately computed losses), any expense of the corporation that is not deductible and not properly chargeable to capital account, and certain deductions for depletion for any oil and gas property held by the S corporation. Under section 1367(b)(2)(A), if for any taxable year the amounts specified in section 1367(a)(2) (other than distributions) exceed the amount which reduces the shareholder's basis to zero, such excess losses and deductions shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder. Section 1367(b)(2)(B) provides that if a shareholder's basis in indebtedness is reduced for any taxable year, any net increase (the amount by which the items described in section 1367(a)(1) exceed the items described in section 1367(a)(2)) for any subsequent taxable year is applied to restore the reduction in basis in indebtedness before any of the excess is used to increase basis in stock.

On January 3, 1994, the Treasury Department and the IRS published final regulations under section 1367 of the Code (T.D. 8508, 1994-1 C.B. 219 [59 FR 12], amended on December 22, 1999 (T.D. 8852, 2000-1 C.B. 253 [64 FR 71641])). Those final regulations relate, in part, to adjustments to basis in both stock of shareholders and indebtedness of an S corporation to its shareholders. Section 1.1367-2 of the Income Tax Regulations provides specific rules for required adjustments (reductions and restorations) to basis in any indebtedness of an S corporation to a shareholder. Section 1.1367-2(a) also provides that for purposes of adjustments to basis of indebtedness to shareholders, shareholder advances not evidenced by separate written instruments and repayments on the advances (open account debt) are treated as a single indebtedness. The basis adjustment rules under the final regulations apply to all indebtedness of an S corporation to a shareholder, whether the indebtedness is evidenced by a written instrument or is open account debt. Taxpayers should also remember that all advances to an S corporation by a shareholder are subject to the general tax principles for debt, whether evidenced by a written instrument or not.

On August 25, 2005, the Tax Court issued its decision in *Brooks v. Commissioner*, TC Memo. 2005-204, involving open account debt. Under its interpretation of §1.1367-2, the court in *Brooks* held "that the basis of the open account indebtedness is properly computed by netting at the close of the year advances of open account debt during the year and repayments of open account debt during the year." This allowed the taxpayer in *Brooks* to defer indefinitely the recognition of income on any repayment of his open account debt over the several years during which the taxpayer and the S corporation made advances and repayments, respectively.

On April 12, 2007, the Treasury Department and the IRS published a notice of proposed rulemaking and a notice of public hearing (REG-144859-04, 2007-20 I.R.B. 1245) in the **Federal Register** (72 FR 18417) proposing amendments to the regulations relating to the treatment of open account debt between S corporations and their shareholders. A public hearing on the proposed regulations was scheduled for July 31, 2007, but was cancelled because no one requested to speak. However, comments responding to the proposed regulations were received. After consideration of these comments, the proposed regulations are

adopted as revised by this Treasury decision. These final regulations generally retain the provisions of the proposed regulations with the modifications discussed in the preamble.

Summary of Comments and Explanation of Revisions

1. Need for Regulatory Change

All of the comments received in response to the proposed regulations suggested that the regulations were overly broad and should be withdrawn. Two commentators suggested that amending the regulations for open account debt is not an appropriate approach for the Treasury Department and the IRS to address concerns regarding transactions similar to that in *Brooks*. Instead, the commentators asserted, such concerns should be addressed through established judicial doctrines such as substance over form, business purpose, sham transaction, and economic substance. One commentator alternatively recommended a narrowly tailored anti-abuse rule targeting open account debt instead of broader rules that would apply to all such debt.

The Treasury Department and the IRS continue to believe that regulatory guidance on open account debt is necessary. The Treasury Department and the IRS believe that the treatment of open account debt as interpreted in *Brooks* permits tax consequences that are inconsistent with the original purpose of §1.1367-2 and is not conducive to sound tax administration. Neither established judicial doctrines alone nor a narrowly tailored anti-abuse rule suggested by the commentators would adequately address these concerns, though the Treasury Department and the IRS continue to recognize the applicability of the judicial doctrines in appropriate cases in addition to these final regulations.

2. Aggregate Principal Threshold Amount

The proposed regulations defined open account debt as shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances (net of repayments on advances) did not exceed \$10,000 per shareholder at the close of any day during the S corporation's taxable year. Shareholders were required to determine for open account debt purposes whether shareholder advances and repayments on the advances exceeded the \$10,000 aggregate principal threshold on any day during the S corporation's taxable year. To make such a determination, shareholders were required to maintain a "running balance" of shareholder advances and repayments on advances, and the outstanding principal amount of the open account debt. If the resulting aggregate principal of the running balance exceeded \$10,000 at the close of any day during the S corporation's taxable year, the entire principal amount of the indebtedness would no longer constitute open account debt effective at the close of that day.

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.

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.

As noted in the preamble to the proposed regulations, the \$10,000 aggregate principal threshold amount for open account debt for purposes of §1.1367-2 was modeled after section 7872(c)(3) and the *de minimis* exception for corporation-shareholder loans in §1.7872-9 of the proposed regulations. However, the Treasury Department and the IRS do not believe it is necessary that the threshold amount for open account debt be modeled after the rules under §1.7872-9 regarding corporate-shareholder loans. Nevertheless, despite the \$25,000 threshold amount for open account debt in these final regulations, the provisions under section 7872 and related regulations for corporate-shareholder loans in excess of \$10,000 separately apply to open account debt in excess of \$10,000 for each advance if the corporation is not obligated to pay a market rate of interest on the advances.

3. Monitoring the Aggregate Principal Threshold Amount

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.

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.

4. Character of Income/Gain Recognition

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.

5. Effective Date Operation

The effective date in the proposed regulations provided that the proposed rules for open account debt applied to any shareholder advances to the S corporation made on or after the date the regulations were published as final regulations and repayments on those advances by the S corporation. Thus, all open account debt (net of repayments) prior to the publication of the final regulation was outside the scope of the proposed regulations, irrespective of the outstanding principal amount.

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 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).

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.

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.

Effective/Applicability Date

The regulations apply to any and all shareholder advances to the S corporation made on or after October 20, 2008, and repayments on those advances by the S corporation.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Section 1.1367-2 also issued under 26 U.S.C. 1367(b)(2).* * *

Par. 2. Section 1.1367-2 is amended as follows:

1. Paragraph (a) is revised.
2. Paragraphs (c)(2) and (d)(1) are revised.
3. Paragraph (d)(2) is redesignated as paragraph (d)(3) and new paragraph (d)(2) is added.
4. Paragraph (e) is amended by adding *Examples 6, 7 and 8*.

The revisions and additions read as follows:

§1.1367-2 Adjustments to basis of indebtedness to shareholder.

(a) *In general*—(1) *Adjustments under section 1367*. This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness (including open account debt as described in paragraph (a)(2) of this section) of an S corporation to a shareholder. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section in accordance with the timing rules in paragraph (d) of this section.

(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.

(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 a shareholder in this section.

(c) ***

(2) *Multiple indebtedness.* If a shareholder holds more than one indebtedness (including any open account debt and any debt treated as a single indebtedness under paragraph (a)(2)(ii) of this section) as of the beginning of an S corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness (including any open account debt and any debt treated as a single indebtedness under paragraph (a)(2)(ii) of this section) in proportion to the amount that the basis of each outstanding indebtedness has been reduced under section 1367(b)(2)(A) and paragraph (b) of this section and not restored under section 1367(b)(2)(B) and this paragraph (c).

(d) *Time at which adjustments to basis of indebtedness are effective—(1) In general.* The amounts of the adjustments to basis of indebtedness (including open account debt) provided in section 1367(b)(2) and this section are determined as of the close of the S corporation's taxable year, and the adjustments are generally effective as of the close of the S corporation's taxable year. However, if the shareholder is not a shareholder in the S corporation at that time, these adjustments are effective immediately before the shareholder terminates his or her interest in the S corporation. Except as provided in paragraph (d)(2) of this section, if a debt is disposed of or repaid in whole or in part before the close of the taxable year, the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the disposition or the first repayment on the debt during the taxable year. To the extent any indebtedness of the S corporation to the shareholder is disposed of or repaid (in whole or in part) during the taxable year and the shareholder's basis in that indebtedness has been reduced under paragraph (b) of this section and is not restored completely under paragraph (c) of this section, the disposition or repayment is a recognition event effective immediately before the indebtedness is disposed of or repaid (in whole or in part).

(2) *Open account debt—(i) In general.* All advances and repayments on open account debt (as described in paragraph (a)(2)(i) of this section) during the S corporation's taxable year are netted at the close of the S corporation's taxable year to determine the amount of any net advance or net repayment. The net advance or net repayment is combined with the outstanding aggregate principal balance of the existing open account debt and that amount is carried forward to the beginning of the subsequent taxable year as the outstanding aggregate principal amount of the open account debt (unless the aggregate principal amount meets the exception defined in paragraph (a)(2)(ii) of this section at the close of the taxable year). However, if the shareholder in the S corporation is not a shareholder of the S corporation at the close of the S corporation's taxable year, such advances and repayments on open account debt are netted, and the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the shareholder terminates his or her interest in the S corporation. If any open account debt is disposed of before or upon the close of the taxable year, the disposition is effective at the close of the S corporation's taxable year, and all advances and repayments are netted immediately prior to the disposition and the basis of that indebtedness is restored under paragraph (c) of this section, effective at the close of the S corporation's taxable year.

(ii) *Exception.* Shareholder indebtedness that is open account debt at the beginning of the taxable year but meets the exception defined in paragraph (a)(2)(ii) of this section at the close of the taxable year, adjustments to the basis of the indebtedness for that taxable year follow the provisions for open account debt. The resulting aggregate principal amount of indebtedness is treated as the principal amount of a debt evidenced by a separate written instrument for any subsequent taxable year, and is no longer subject to the open account debt provisions of this section.

(e) * * *

Example 6. The \$25,000 aggregate principal amount applies to each shareholder. (i) A and B have been the two shareholders in Corporation S since 2000. As of the end of the 2008 taxable year, the bases of A's and B's stock are both zero. On June 1, 2009, A advances S \$16,000, which is not evidenced by a written instrument. On August 1, 2009, B advances S \$22,000, which is not evidenced by a written instrument. Both the \$16,000 advance and the \$22,000 advance are open account debt and remain outstanding at those amounts during 2009. There is no net increase under paragraph (c) of this section in year 2009.

(ii) At the close of the 2009 taxable year, A's open account debt does not exceed \$25,000. A therefore carries forward to the beginning of the 2010 taxable year the \$16,000 as open account debt.

(iii) At the close of the 2009 taxable year, B's open account debt does not exceed \$25,000. B therefore carries forward to the beginning of the 2010 taxable year the \$22,000 as open account debt.

Example 7. Treatment of open account debt. (i) The facts are the same as in *Example 6*, in addition to which, on December 31, 2009, A's basis in the open account debt is reduced under paragraph (b) of this section to \$8,000. On April 1, 2010, S repays A \$4,000 of the open account indebtedness. On September 1, 2010, A advances S an additional \$1,000, which is not evidenced by a written instrument. There is no net increase under paragraph (c) of this section in year 2010.

(ii) The \$4,000 April repayment S makes to A and A's \$1,000 September advance are netted to result in a net repayment of \$3,000 for the taxable year on A's \$16,000 open account debt carried forward from 2009. Because there is no net increase in 2010, no basis of indebtedness is restored for the 2010 taxable year, and A realizes \$1,500 of income on the \$3,000 net repayment at the close of the 2010 taxable year.

(iii) At close of the 2010 taxable year, A's open account debt does not exceed \$25,000. The net repayment of \$3,000 for the taxable year on A's \$16,000 open account debt carried forward from 2009, leaves A with an open account debt of \$13,000 to carry forward as open account debt to the beginning of the 2011 taxable year.

Example 8. Treatment of shareholder indebtedness not evidenced by a written instrument which exceeds \$25,000. (i) The facts are the same as in *Example 7*, in addition to which, on February 1, 2011, S repays \$5,000 of the open account debt and on March 1, 2011, A advances S \$20,000, which is not evidenced by a written instrument.

(ii) At the close of the 2010 taxable year, A has an open account debt of \$13,000 to carry forward as open account debt to the beginning of the 2011 taxable year.

(iii) The 2011 advances and repayments are netted to result in a net advance of \$15,000 on A's \$13,000 open account debt carried forward from 2010, increasing A's open account debt to \$28,000 as of the close of the 2011 taxable year. Because A's open account debt exceeds \$25,000, for any subsequent taxable year the \$28,000 indebtedness will be treated in the same manner as indebtedness evidenced by a separate written instrument for the purposes of this section. Because there is no net increase in 2011, no basis of indebtedness is restored for the 2011 taxable year.

Par. 3. Section 1.1367-3 is revised to read as follows:

§1.1367-3 Effective/Applicability date.

Section 1.1367-2(a), (c)(2), (d)(2), and (e) *Example 6*, *Example 7*, and *Example 8* apply to any shareholder advances to the S corporation made on or after October 20, 2008, and repayments on those advances by the S corporation. The rules that apply with respect to shareholder advances to the S corporation made before October 20, 2008, are contained in §1.1367-3 in effect prior to October 20, 2008. (See 26 CFR part 1 revised as of April 1, 2007.) Shareholders have the option to apply these rules to shareholder advances to the S corporation made before October 20, 2008, and repayments on those advances by the S corporation.