

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-134042-07]

RIN 1545-BG81

Basis of Indebtedness of S Corporations to their Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to basis of indebtedness of S corporations to their shareholders. These proposed regulations provide that S corporation shareholders increase their basis of indebtedness of the S corporation to the shareholder only if the indebtedness is bona fide. The proposed regulations affect shareholders of S corporations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Requests to speak and outlines of topics to be discussed at the public hearing scheduled for **October 8, 2012**, must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-134042-07), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8

a.m. and 4 p.m. to CC:PA:LPD:PR (REG-134042-07), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-134042-07). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Caroline E. Hay at (202) 622-3070; concerning the submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) P. Taylor at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### **Background**

This document proposes amendments to §1.1366-2 of the Income Tax Regulations. In addition, this document proposes conforming changes to the effective date rules provided in §1.1366-5.

Under section 1366(d)(1) of the Internal Revenue Code (Code), the aggregate amount of losses and deductions that a shareholder takes into account for any taxable year cannot exceed the sum of that shareholder's adjusted basis in stock and adjusted basis of any indebtedness of the S corporation to that shareholder. The Senate Report discussing section 1374 (the predecessor statute to section 1366) illustrates Congress's intent to limit the loss that a shareholder takes into account to that shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of

the corporation to the shareholder. S. Rept. 1983, 85th Cong., 2d Sess. 219-220 (1958) (1958-3 CB 922, 1141).

Section 1.1366-2 provides rules relating to limitations on deduction of passthrough items of an S corporation to its shareholder. Under §1.1366-2(a)(1), a shareholder's aggregate amount of losses and deductions taken into account under §1.1366-1(a)(2), (3), and (4) for any taxable year of the S corporation cannot exceed that shareholder's adjusted basis in stock in the corporation and adjusted basis of any indebtedness of the corporation to that shareholder. These proposed amendments to the regulations provide that, in order to increase a shareholder's basis of indebtedness, a loan must represent bona fide indebtedness of the S corporation that runs directly to the shareholder. These proposed regulations also reaffirm that a shareholder acting as guarantor of S corporation indebtedness does not create or increase basis of indebtedness simply by becoming a guarantor.

### **Explanation of Provisions**

Section 1366(d)(1) provides that a shareholder can take into account losses and deductions to the extent of the adjusted basis of the shareholder's stock and the adjusted basis of any indebtedness of the S corporation to the shareholder (basis of indebtedness). The Code does not define basis of indebtedness, but several court cases involving passthrough losses from an S corporation interpret section 1366 to require an investment in the S corporation that constitutes "an actual economic outlay" by the shareholder to create basis of indebtedness. See, for example, Maloof v. Comm'r, 456 F.3d 645, 649-650 (6th Cir. 2006); Spencer v. Comm'r, 110 T.C. 62, 78-79 (1998), aff'd without published opinion, 194 F.3d 1324 (11th Cir. 1999); Hitchins v.

Comm'r, 103 T.C. 711, 715 (1994); Perry v. Comm'r, 54 T.C. 1293, 1296 (1970). Often, the cases involve attempts by an S corporation shareholder to obtain basis of indebtedness by borrowing from another person—typically, a related entity—and then lending the proceeds to the S corporation (a back-to-back loan transaction). Alternatively, an S corporation shareholder might seek to restructure an existing loan of the S corporation into a back-to-back loan by assuming the S corporation’s liability on the loan and creating a commensurate obligation from the S corporation to the shareholder. Disputes continue to arise concerning when a back-to-back loan gives rise to an actual economic outlay, in particular whether a shareholder has been made “poorer in a material sense” as a result of the loan. See, for example, Oren v. Comm'r, 357 F.3d 854, 857-859 (8th Cir. 2004); Bergman v. U.S., 174 F.3d 928, 932 (8th Cir. 1999).

The frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions involving multiple parties, including back-to-back loan transactions, create shareholder basis of indebtedness demonstrates the complexity of and uncertainty about this issue for both shareholders and the government. The Treasury Department and the IRS propose these regulations to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness. These proposed regulations require that loan transactions represent bona fide indebtedness of the S corporation to the shareholder in order to increase basis of indebtedness; therefore, an S corporation

shareholder need not otherwise satisfy the “actual economic outlay” doctrine for purposes of section 1366(d)(1)(B).

The key requirement of these proposed regulations is that purported indebtedness of the S corporation to a shareholder must be bona fide indebtedness to the shareholder. These proposed regulations do not attempt to provide a different standard for purposes of section 1366 as to what constitutes bona fide indebtedness. Rather, general Federal tax principles—many of which have developed outside of section 1366—determine whether indebtedness is bona fide. See, for example, Knetsch v. U.S., 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); Geftman v. Comm’r, 154 F.3d 61, 68-75 (3d Cir. 1998) (based on the objective attributes and the economic realities of the transaction, holding that the transaction at issue was not a bona fide debt); Estate of Mixon v. U.S., 464 F.2d 394, 402 (5th Cir. 1972) (discussion of factors indicative that debt is bona fide); Litton Business Systems, Inc. v. Comm’r, 61 T.C. 367, 376-77 (1973).

By contrast, shareholder guarantees of S corporation debt do not result in basis of indebtedness. An overwhelming majority of courts considering whether shareholders may increase basis of indebtedness from their guarantees of S corporation debt determined that the shareholders’ guarantees did not create basis of indebtedness. Where an S corporation shareholder acts merely as a guarantor of a loan made by another party directly to the S corporation, or acts in a capacity similar to a guarantor (for example, as a surety or accommodation party), then the courts have held that the shareholder adjusts basis of indebtedness only to the extent the shareholder actually performs under the guarantee. See, for example, Estate of Leavitt v. Comm’r, 875 F.2d

420 (4th Cir. 1989); Frankel v. Comm'r, 61 T.C. 343 (1973), aff'd without published opinion, 506 F.2d 1051 (3d Cir. 1974); Raynor v. Comm'r, 50 T.C. 762 (1968); Weisberg v. Comm'r, T.C. Memo. 2010-55; Maloof v. Comm'r, T.C. Memo. 2005-75, aff'd, 456 F.3d 645 (6th Cir. 2006); Wise v. Comm'r, T.C. Memo. 1997-135. But see Selfe v. U.S., 778 F.2d 769 (11th Cir. 1985) (holding that under unique and limited circumstances, a shareholder who guarantees a loan to an S corporation may increase basis of indebtedness where, in substance, that shareholder has borrowed funds and subsequently advanced them to the S corporation). These proposed regulations provide that an S corporation shareholder who merely acts as a guarantor or in a similar capacity has not created basis of indebtedness unless the shareholder actually makes a payment, and then only to the extent of such payment. See also Rev. Rul. 70-50 (1970-1 CB 178), (see §601.601(d)(2)).

Additionally, some taxpayers have relied on an “incorporated pocketbook” theory to claim an increase in basis of indebtedness in circumstances that involve a loan directly to the S corporation from an entity related to the S corporation shareholder. In these transactions, an S corporation shareholder claims that a transfer from the related entity directly to the shareholder’s S corporation was made on the shareholder’s behalf and is, in substance, a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S corporation. A limited number of court decisions have allowed shareholders to increase basis of indebtedness as a result of incorporated pocketbook transactions. See Yates v. Comm'r, T.C. Memo. 2001-280; Culnen v. Comm'r, T.C. Memo. 2000-139. Under these proposed regulations, an incorporated pocketbook transaction increases basis of indebtedness only where the transaction

creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation.

These proposed regulations only address whether a shareholder has basis of indebtedness for purposes of section 1366(d)(1)(B) and do not address how to determine the basis of the shareholder's stock in the S corporation for purposes of section 1366(d)(1)(A). Therefore, these proposed regulations leave unchanged the conclusion found in published guidance that a shareholder of an S corporation does not increase basis in stock for purposes of section 1366(d)(1)(A) upon the contribution of the shareholder's own unsecured demand promissory note to the corporation. Rev. Rul. 81-187 (1981-2 CB 167). This conclusion is consistent with published guidance and case law in the partnership context that the contribution of the partner's own note will not increase such partner's basis in its partnership interest under section 722. Rev. Rul. 80-235 (1980-2 CB 229); Oden v. Comm'r, T.C. Memo. 1981-184, aff'd without published opinion, 679 F.2d 885 (4th Cir. 1982) (because the partner incurred no cost in making the note, the partner's basis in the note to him was zero). In developing this project, the Treasury Department and the IRS have considered whether the principal holding of Rev. Rul. 81-187, and the holding of Rev. Rul. 80-235 as it relates to a partner's basis in its partnership interest upon the contribution of the partner's own note, should be promulgated as regulations. The Treasury Department and the IRS have considered alternatives to the discussion of the applicable law in those revenue rulings. As one model, the Treasury Department and the IRS have, with respect to basis calculations in the S corporation and partnership context, considered adopting a rule similar to the one currently in §1.704-1(b)(2)(iv)(d)(2), which provides that a partner's

capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note. The Treasury Department and the IRS request comments concerning the propriety of this model in the S corporation and the partnership context.

### **Proposed Effective Date**

The regulations, as proposed, apply to loan transactions entered into on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. 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 proposed regulations. Because these proposed 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury



Department and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying.

A public hearing has been scheduled for **October 8, 2012**, beginning at 10 a.m. in the auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by **INSERT DATE 90 DAYS AFTER PUBLICATIOIN OF THIS DOCUMENT IN THE FEDERAL REGISTER**. A period of 10 minutes is allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

The principal authors of these proposed regulations are Caroline E. Hay, Michael H. Beker, and Stacy L. Short, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

## List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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 \* \* \*

### §1.108-7 [Amended]

Par. 2. Section 1.108-7 is amended by:

1. Removing the language “§1.1366-2(a)(5)” in paragraph (d)(2)(iii) and adding “§1.1366-2(a)(6)” in its place.

2. Adding a sentence to the end of paragraph (f)(2).

The addition reads as follows:

#### §1.108-7 Reduction of attributes.

\* \* \* \* \*

(f) Effective/applicability date.

(2) \* \* \* The revision to the citation to §1.1366-2(a) in paragraph (d)(2)(iii) of this section is applicable on and after the date these proposed regulations are published as final in the **Federal Register**.

\* \* \* \* \*

### §1.1366-0 [Amended]

Par. 3. Section 1.1366-0 is amended by:

1. Redesignating paragraphs (a)(2), (a)(3), (a)(4), (a)(5), and (a)(6) as paragraphs (a)(3), (a)(4), (a)(5), (a)(6), and (a)(7) in the table of contents for §1.1366-2, respectively, and adding a new paragraph (a)(2).

2. Revising the title of §1.1366-5 in the table of contents.

The additions read as follows:

§1.1366-0 Table of contents.

\* \* \* \* \*

§1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) \* \* \*

(2) Basis of indebtedness.

(i) In general.

(ii) Guarantees.

(iii) Examples.

\* \* \* \* \*

§1.1366-5 Effective/Applicability date.

**§1.1366-2 [Amended]**

Par. 4. Section 1.1366-2 is amended by:

1. Redesignating paragraphs (a)(2), (a)(3), (a)(4), (a)(5), and (a)(6) as paragraphs (a)(3), (a)(4), (a)(5), (a)(6), and (a)(7) respectively, and adding a new paragraph (a)(2).

2. Removing the language “(a)(3)(i)” in paragraph (a)(1)(i), and adding the language “(a)(4)(i)” in its place.

3. Removing the language “paragraph (a)(3)(ii)” in paragraph (a)(1)(ii), and Adding the language “paragraphs (a)(2) and (a)(4)(ii)” in its place.

4. Removing the language “(a)(3)(i) and (ii)” in newly redesignated paragraph (a)(3), and adding the language “(a)(4)(i) and (ii)” in its place.
5. Removing the language “paragraphs (a)(1)(i) and (2)” in newly redesignated paragraph (a)(4)(i), and adding the language “paragraphs (a)(1)(i) and (3)” in its place.
6. Removing the language “paragraphs (a)(1)(ii) and (2)” in newly redesignated paragraph (a)(4)(ii), and adding “paragraphs (a)(1)(ii) and (3)” in its place.
7. Removing the language “(a)(3)(i)” and “(a)(3)(ii)” in newly redesignated paragraph (a)(5), and adding the language “(a)(4)(i)” and “(a)(4)(ii)”, respectively, in their place.
8. Removing the language “(a)(5)(ii)” in newly redesignated paragraph (a)(6)(i) and (a)(6)(iii), and adding the language “(a)(6)(ii)” in its place.
9. Removing the language “(a)(4)” in newly redesignated paragraph (a)(6)(ii), and adding the language “(a)(5)” in its place.
10. Removing the language “paragraphs (a)(1)(i) and (2)” in newly redesignated paragraph (a)(7), and adding the language “paragraphs (a)(1)(i) and (3)” in its place.

The additions read as follows:

§1.1366-2 Limitations on deduction of passthrough items of an S corporation to its shareholders.

(a) \* \* \*

(2) Basis of indebtedness--(i) In general. The term basis of any indebtedness of the S corporation to the shareholder means the shareholder’s adjusted basis (as defined in §1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether

indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

(ii) Guarantees. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, based on the facts and circumstances, the shareholder may increase its basis of indebtedness to the extent of that payment.

(iii) Examples. The following examples illustrate the provisions of paragraph (a)(2)(i) and (ii) of this section:

Example 1. Shareholder loan transaction. A is the sole shareholder of S, an S corporation. S received a loan from A. Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness under paragraph (a)(2)(i) of this section. The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under §301.7701-3.

Example 2. Guarantee. A is a shareholder of S, an S corporation. In 2013, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2014, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2014 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

Example 3. Back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loaned \$200,000 to A. A then loaned \$200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

Example 4. Loan restructuring through distributions. A is the sole shareholder of two S corporations, S1 and S2. In March 2013, S1 made a loan to S2. In December 2013, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2 under paragraph (a)(2)(i) of this section.

\* \* \* \* \*

### **§1.1366-5 [Amended]**

Par. 5. Section 1.1366-5 is amended by:

1. Removing the language “Sections 1.1366-2(a)(5)(i), (ii) and (iii)”, and adding the language “Sections 1.1366-2(a)(6)(i), (ii) and (iii)” in its place.
2. Adding two sentences to the end of the paragraph.

The additions read as follows:

#### §1.1366-5 Effective/Applicability date.

\* \* \* Upon the publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**, §1.1366-2(a)(2) will apply to transactions entered into on or after the date these proposed regulations are published as final in the **Federal Register**. In addition, the revisions to §§1.1366-0, 1.1366-2, and this section are applicable on and after the date these proposed regulations are published as final in the **Federal Register**.

### **§ 1.1367-1 [Amended]**

Par. 6. Section 1.1367-1(h) Example 5(iii) is amended by removing the language “§1.1366-2(a)(2)” in the third and fourth sentences and adding the language “§1.1366-2(a)(3)” in its place.

**§ 1.1367-3 [Amended]**

Par. 7. Section 1.1367-3 is amending by adding one sentence to the end of the paragraph to read as follows:

§1.1367-3 Effective/Applicability date.

\* \* \* The revisions to citations to §1.1366-2(a) in §1.1367-1(h) Example 5(iii) are applicable on and after the date these proposed regulations are published as final in the **Federal Register**.

Steven T. Miller,  
Deputy Commissioner for Services and Enforcement.

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