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August 31, 2007

Mr. Kevin Brown
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 1367 of the Internal Revenue Code regarding the Treatment of Open Account Debt of S Corporations

Dear Acting Commissioner Brown:

Enclosed are comments on proposed regulations under section 1367 of the Internal Revenue Code, regarding the treatment of open account debt of S corporations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
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COMMENTS CONCERNING PROPOSED REGULATIONS UNDER SECTION 1367 OF THE INTERNAL REVENUE CODE REGARDING THE TREATMENT OF OPEN ACCOUNT DEBT OF S CORPORATIONS

The following comments (the “Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Kevin D. Anderson of the Section’s Committee on S Corporations (the “Committee”). Substantive contributions were made by Thomas J. Nichols. The Comments were reviewed by Carol Kulish Harvey, Chair of the Committee. The Comments were further reviewed by C. Wells Hall III of the Section’s Committee on Government Submissions, and by Barbara Spudis de Marigny, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the Federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: August 31, 2007

Executive Summary

These Comments relate to the request for comments contained in the preamble to the proposed regulations (the “Proposed Regulations”) relating to the treatment of “open account debt” under Regulation section 1.1367-2 as published in the Federal Register on April 12, 2007.¹

The preamble to the Proposed Regulations makes clear that the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”) have drafted the Proposed Regulations, at least in part, in response to a 2005 Tax Court memorandum decision, *Brooks v. Commissioner*, T.C. Memo. 2005-204. We believe that the Proposed Regulations represent an inappropriately broad response to the results of this case. The Proposed Regulations, if adopted as final regulations, would significantly increase the recordkeeping burdens imposed on S corporations (which most frequently constitute small businesses) and their shareholders, creating substantial compliance burdens for a host of taxpayers that are not engaging in any tax abuse or avoidance. Similarly, the Proposed Regulations would create a trap for unwary taxpayers that cannot afford to pay sophisticated advisors for assistance in interpreting the regulatory requirements or tracking daily balances of debt. Broadly imposing such compliance burdens would contravene the purpose of the open account debt rules, which the Service itself recognizes to be “to provide administrative simplicity for S corporations.”²

We do not believe the *Brooks* decision presents the type of significant opportunity for abuse that necessarily requires a change in the Regulations. Nonetheless, to the extent the Treasury and Service conclude that it is necessary to amend the Regulations in response to the *Brooks* decision, we believe that their concerns could be addressed through a substantially more limited rule that imposes less of a compliance burden on small businesses. Specifically, we recommend that, instead of modifying the definition of open account debt in the manner set forth in the Proposed Regulations, the Treasury and Service instead add a regulatory anti-abuse rule that precludes netting advances and repayments in certain situations.

If Treasury and the Service decide to adhere to a dollar threshold to limit the amount of open account debt, we believe that modifying the approach in the Proposed Regulations in the following manner would better balance the compliance burdens imposed on small businesses that are engaged in legitimate financing arrangements with the government’s apparent objective of limiting the application of those rules to those situations it views as non-abusive:

- The dollar threshold should be increased from \$10,000 to at least \$100,000.
- If a running daily balance approach is adopted in the Regulations, when finalized, shareholder advances should lose their status as open account

¹ 72 Fed. Reg. 18417 (Apr. 12, 2007).

² *Id.*

debt only if *both* the amount of the advances exceeds the applicable threshold amount on any day of the year *and* the balance at the end of the year exceeds the average of the daily balances throughout the year.

- In order to reduce the recordkeeping burdens imposed on a substantial number of affected shareholders, the balance of the advances should have to be maintained and adjusted only at least as often as the taxpayer maintains and updates its books and records (rather than daily).
- Certain types of debt should be treated as open account debt, regardless of their amount.

Comments

1. Introduction

Under the existing Regulations, all open account debt of a single shareholder advanced to an S corporation is treated as a single indebtedness for the purpose of the basis adjustment rules under subchapter S and the tax consequences of repayment or other disposition of that indebtedness. In addition, open account debt is not considered to have been repaid, in whole or in part, during the taxable year of an S corporation if the aggregate balance of the indebtedness at the end of the year is equal to or greater than the aggregate balance of the indebtedness at the beginning of the year. Where such indebtedness has been used as the basis for claiming losses allocated to the shareholder-lender by the S corporation, the basis of the indebtedness is impaired, and the repayment of that indebtedness before basis is restored will require the shareholder to recognize income or gain. In contrast, if a series of shareholder loans is not treated as open account debt, new advances and repayments may not be netted together and must be accounted for separately. If any of the indebtedness has become basis-impaired as the result of losses allocated to a shareholder, the repayment of such indebtedness will give rise to taxable income or gain upon repayment to the shareholder-creditor. The existing Regulations impose only one requirement on open account debt, namely, that it *not* be evidenced by a separate written instrument.

The Preamble to the Proposed Regulations confirms that the concept of open account debt set forth in the existing Regulations was intended to provide administrative simplicity for S corporations. By treating open account debt of a shareholder as a single indebtedness for purposes of section 1367,³ a shareholder would only be required to determine whether such single indebtedness reflected a net increase or a net decrease in principal amount during a taxable year. If the indebtedness reflected a net increase for the year, the increased debt would provide additional basis for utilizing allocated losses of the S corporation. If the indebtedness reflected a net decrease for the year, the net amount repaid would be assigned tax consequences under the rules generally applicable to the repayment of impaired-basis indebtedness of an S corporation.

The Proposed Regulations were issued, at least in part, in response to a 2005 Tax Court memorandum decision, *Brooks v. Commissioner*, T.C. Memo. 2005-204. In *Brooks*, the Tax Court was presented with a pattern of advances near the end of the corporation's taxable year and repayments of those advances shortly after the beginning of the next taxable year. The amounts advanced by the two shareholders to the corporation were borrowed from a bank, and the shareholders repaid the bank when the corporation repaid the advances. This pattern was repeated in several consecutive years, and the shareholders deducted losses allocated to them by the S corporation for each of those years. At the end of the second year, the taxpayers not only advanced funds sufficient to cover the current year's losses, but also advanced funds representing the

³ All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise expressly stated herein, and references to regulations are to the Treasury Regulations issued under the Code.

amounts repaid at the beginning of the year. However, the taxpayers asserted that, because the advances met the definition of open account debt under the regulations, the aggregate effect of these transactions was to create a net increase in the single indebtedness for the year. Based on the parties' stipulation that the advances were open account debt, the court held that the taxpayers properly accounted for the advances and repayments by netting the two together. Thus, not only were the taxpayers not required to account for any repayment of the advances, but the taxpayers also were permitted to deduct the additional losses of the S corporation allocated to the taxpayers for the year.

The Proposed Regulations would retain the general rules that "open account debt" means shareholder advances not evidenced by separate written instruments and repayments on the advances, and that open account debt is treated as a single indebtedness. The Proposed Regulations would add the requirement that the aggregate outstanding principal of open account debt cannot exceed \$10,000 at the close of any day during the S corporation's taxable year. Separate advances under a line of credit that are not evidenced by a separate written instrument also would be included in the definition of open account debt. In order to determine whether debt of the S corporation to a shareholder exceeds \$10,000, the Proposed Regulations would require the shareholder to maintain a "running daily balance" of all advances and repayments. If the aggregate outstanding principal amount of the debt exceeds \$10,000 at the close of any day, the debt would cease to qualify as open account debt at the close of that day and would have to be treated thereafter as though it were a separate indebtedness that is evidenced by a separate written instrument ("separate unwritten debt"). Any subsequent advances from the shareholder to the S corporation could be treated as new open account debt (provided they do not exceed the \$10,000 threshold).

The Proposed Regulations also address the manner in which repayments on open account debt are treated. Specifically, at the end of the taxable year, the shareholder would net all advances and repayments made during the year without regard to the principal amount of the open account debt. If, at the end of the year, there were a net repayment, it would be taken into account effective at the end of the taxable year. If, at the end of the year, there were a net advance, it would be carried forward and added to the outstanding aggregate principal amount of the open account debt. In general, a net repayment (or disposition) of open account debt the basis of which is impaired⁴ and not fully restored under Regulation section 1.1367-2(c) would result in income recognition as of the end of the taxable year under Proposed Regulation section 1.1367-2(d)(2)(i). Nevertheless, Proposed Regulation section 1.1367-2(d)(1) would provide that repayment (or disposition) during the taxable year of any debt (including open account and separate unwritten debt) the basis of which is impaired and is not fully restored would result in gain recognition immediately before such repayment or disposition. Presumably, repayment or disposition of debt the basis of which is not impaired would not result in income or gain to the shareholder.

⁴ Under section 1366(d), the basis of indebtedness of the S corporation to the shareholder can be used to claim losses, deductions, and certain expenses of the S corporation allocated to the shareholder, and under section 1367(b)(2), the shareholder's basis in the indebtedness is reduced (but not below zero) to the extent such losses, deductions, and expenses exceed the shareholder's basis in stock of the S corporation.

2. *The Proposed Regulations are an Overly Broad Response to the Brooks decision*

We respectfully submit that the *Brooks* decision does not provide the type of significant opportunity for abuse for which a regulatory change—particularly a complex and burdensome change—is necessary or appropriate. Unfortunately, the Preamble to the Proposed Regulations does not elaborate upon the government’s particular concern with the decision or facts of the case, other than to indicate that the “deferral” allowed in that case was not intended by the existing Regulations. Although not explicitly stated in the Preamble, it is possible that Treasury and the Service were troubled by the fact that the investment in each year’s loan was recovered (through the deduction of allocated current losses) before the basis was restored through income allocations. It also is possible that Treasury and the Service simply were concerned with the particular (and unusual) facts of the case, *i.e.*, that there was a short time period, spanning the ends of taxable years, between advances and repayments

In this regard, it is worth pointing out that, in *Brooks*, the taxpayers’ loans to the corporation may not have been without some substantive significance. The shareholders in that case incurred the costs and risks associated with their borrowing arrangements with an outside lender. Perhaps more importantly, in the event that the S corporation went into bankruptcy at any time during the succeeding year, payments to the shareholders on their loans would presumably be recoverable as a preference under a bankruptcy rule that applies to preferences paid to insiders within the preceding year.⁵ However, in situations in which loans (or other transactions) do lack substance, the Service has a number of legal principles that it can use to attack or recharacterize such transactions.⁶

3. *The Proposed Regulations Would Impose Significant Compliance Burdens on Small Businesses*

Under the Proposed Regulations “a shareholder must maintain a running daily balance of all advances and repayments on those advances and the outstanding principal amount of the open account debt at the close of each day during the S corporation’s taxable year.” This requirement would impose a significant administrative burden on those closely-held S corporations most likely to have open account debt with their shareholders, in contravention of the notion that the open account debt rules (and the subchapter S rules more generally) are intended to be administratively simple.

The Proposed Regulations appear to be premised on the understanding that an S corporation incurs debt to one of its shareholders only when the shareholder advances money directly to the corporation, and that the corporation repays such debt only when it pays money directly to the shareholder/lender. In fact, however, open account debt may be created in a variety of ways. For example, a shareholder who is also an employee of the corporation may incur many types of expenses on behalf of the corporation, including travel, transportation, and other out-of-pocket expenses. Even if a shareholder is not

⁵ See 11 U.S.C. § 547(b)(4)(B).

⁶ See, *e.g.*, *Cutts v. Commissioner*, T.C. Summ. Op. 2004-8 (netting debts between accounts on a monthly basis for purposes of applying section 7872).

acting in the capacity of an employee, the shareholder may find it necessary to satisfy creditors of the corporation or advance funds on a temporary basis to meet working capital needs. Similarly, repayments can occur in a variety of indirect means, including through the corporation's satisfaction of the shareholder's personal and other expenses and liabilities.

For many closely-held corporations, especially those that are not well funded and able to keep clearly segregated bank accounts and records, the process of reconciliation and accounting may occur only once a year. At that time, both the corporation and the shareholder know what is legitimately charged to the corporation and what is appropriately charged to the shareholder, and the net balance between the corporation and the shareholder at the end of the year can be accurately determined. We do not mean to suggest that such is the best practice, but it is simply the way many honest and marginally-profitable closely-held S corporation businesses are operated. It is unrealistic to expect that small businesses, even substantial businesses, always do or even could calculate the exact amount of the open account debt every day of the year.

Moreover, any rule that pivots on the exact amount of open account debt at the close of each day unavoidably will involve numerous complicated and confusing determinations. For example, when do shareholders "advance" monies charged to their own credit cards for hotels, meals, etc.? Is it when they make reservations, when they check into hotels or order food, when they pay their credit card bills, or when they seek reimbursement from the corporation? If a shareholder is entertaining customers past midnight, should the accountant or bookkeeper review each invoice to determine whether the meals or drinks were consumed before or after the "close of each day"? For that matter, whenever a shareholder turns in expense reimbursement documentation that covers numerous months, perhaps even a whole year, does the accountant or bookkeeper have to review each and every receipt to calculate the running total balance under the Proposed Regulations? As noted above, indirect advances and repayments involving third-party payments may be particularly difficult to track. Most such transactions are accounted for after the fact. We are unaware of any other substantive rule of tax law that requires that each such transaction be assigned to a specific day during the year.⁷

The Proposed Regulations contemplate that there could be numerous separate debts each year resulting from the application of the \$10,000 threshold rule. It is certainly not inconceivable that even a modestly-sized S corporation could have half a dozen or more open account debts, each of which would have to be "treated in the same manner as indebtedness evidenced by a separate written instrument." The Proposed Regulations appear to assume that it will be possible to determine which of these various separate debts is being repaid whenever the corporation transfers cash to a shareholder or advances or pays funds to pay his or her personal expenses. Because open account debt only arises in circumstances where there is no actual written evidence of indebtedness, it

⁷ Of course, the corporation's method of accounting requires a determination as to whether items are paid or incurred before the end of the taxable year or in the following year. However, this exercise is only conducted once a year, and not on a daily, or even monthly, basis.

is likely that all advances and repayments of such debt are run through the same account on the books of the S corporation.

Any attempt to fill this vacuum by regulation would further complicate an already unduly complicated set of rules applicable to what, in the vast majority of circumstances, are legitimate and non-abusive ordinary-course-of-business transactions. Moreover, in most cases, the bottom-line tax consequences to the S corporation shareholder would only be slightly different, sometimes better and sometimes worse.

This conclusion—as well as the complexity associated with the Proposed Regulations—can be demonstrated by the following example. Suppose taxpayer A were the sole shareholder of an S corporation and A's shareholder advances were not evidenced by separate written instruments and were all reflected in one account on the corporation's books. Advances and repayments are made as follows:

January 1 beginning balance	\$11,000
April 14 repayment	(1,000)
April 14 balance	10,000
October 31 advance	<u>12,000</u>
October 31 balance	22,000
November 22 advance	<u>15,000</u>
November 22 balance	37,000
December 3 repayment	(8,000)
December 31 ending balance	<u>\$29,000</u>

Assume that the adjusted basis of the \$11,000 beginning debt balance was \$6,000. Assume further that A has no basis in her stock at either the beginning or the end of the year, and that during the year the S corporation incurs a \$7,000 loss, all of which is allocated to A and reduces the adjusted basis of A's indebtedness.

Under the current Regulations, the treatment of A's indebtedness is fairly straightforward. There was a net increase of \$18,000 in open account debt, and a \$7,000 loss. Thus, none of the open account debt at the beginning of the year is treated as having been repaid. Further, A has \$29,000 of indebtedness with a \$17,000 basis at the end of the year (\$6,000 beginning basis plus \$18,000 net advance for the year, reduced by \$7,000 allocated and allowable loss).

Under the Proposed Regulations, the only thing that seems certain is that, as of April 13 (the date before the \$1,000 repayment), A was treated as having one indebtedness with a principal amount of \$11,000 and an adjusted basis of \$6,000. At the time of the April 14 repayment, there is only one debt outstanding, and the principal repayment would be applied to that debt. The October 31 and November 22 advances would each be treated as a new separate indebtedness under the Proposed Regulations. A question arises under the Proposed Regulations regarding the treatment of the repayment made on December 3. Under the current Regulations, net increases in debt basis are applied first to restore basis reductions that would otherwise trigger gain or income upon

repayment.⁸ The rationale for this provision is to avoid triggering unexpected debt repayment income or gain to an S corporation shareholder who is simply carrying out operations in the ordinary course of business. There is nothing about the issue that the Service faced in the *Brooks* case that would undercut this underlying rationale. Thus, the December 3 repayment would presumably be applied to one or both of the full basis debts, instead of triggering gain on the reduced basis indebtedness from the beginning of the year.⁹ Assuming the repayment application assumptions made above are accurate, Shareholder A would have the following separate debts as of the end of the year:

	January 1 <u>Debt</u>	October 31 <u>Debt</u>	November 22 <u>Debt</u>	Cumulative <u>Total</u>
January 1	\$11,000			\$11,000
April 14	(1,000)			(1,000)
	10,000			10,000
October 31		<u>\$12,000</u>		<u>12,000</u>
		12,000		22,000
November 22			<u>\$15,000</u>	<u>15,000</u>
			15,000	37,000
December 3		(3,556)	(4,444)	(8,000)
December 31	<u>\$10,000</u>	<u>\$8,444</u>	<u>\$10,556</u>	<u>\$29,000</u>

The respective bases of the various debts would be reduced in accordance with Reg. § 1.1367-2(b)(3).

When regulations under sections 1367 and 1368 were originally proposed more than fifteen years ago, individual members of the Section's Committee on S Corporations provided comments on those regulations. Those comments noted that, although treating each separate open account advance as a separate indebtedness would generally increase taxpayer flexibility, such treatment would impose administrative complexity and could create a trap for the unwary. As demonstrated by the above example, the same concerns apply with respect to the approach taken in the Proposed Regulations.

4. *A Carefully Targeted Anti-Abuse Rule Could Address the Concerns Raised by the Brooks Decision Without Imposing Undue Burdens on Small Businesses*

If Treasury and the Service conclude that the *Brooks* decision presents an opportunity for abuse that must be addressed through an amendment to the Regulations, we believe that the response should be tailored to the particular concerns raised by that decision. It appears that the government's primary concern with the result in *Brooks* is that the taxpayers were able to net advances made at the end of the taxable year against

⁸ See Reg. § 1.1367-2(c)(2).

⁹ We assume that, because these two advances represented separate debts, the corporation could affirmatively choose the debt to which any given repayment would apply, in the same manner as it could for indebtedness represented by separate written instruments.

repayments made at the beginning of the year.¹⁰ Consequently, an anti-abuse rule specifically focused on that perceived problem would be much less likely to unnecessarily disrupt the operations of closely-held S corporations and their shareholders than a rule that requires maintaining running balances of the amount of debt not evidenced by written instruments.

There is substantial precedent for such an anti-abuse rule in the S corporation regulations,¹¹ and an appropriately targeted anti-abuse rule could be adopted here. For example, if Treasury and the Service are concerned with the particular fact pattern in *Brooks*, taxpayers could be precluded from netting repayments made earlier in the year against advances made later in the year if a principal purpose of the prior repayment and subsequent advance were to provide basis to shareholders to permit utilization of losses while precluding the corporation from actually using the funds advanced by the shareholders.¹² Such an approach would have the advantage over the Proposed Regulation of not gratuitously complicating the compliance efforts of the vast majority of S corporations that do not engage in the activity targeted in *Brooks*. In any event, an anti-abuse rule should always be articulated in the context of the specific tax-policy principle that is sought to be advanced.¹³

5. At a Minimum, the Proposed Regulations Should be Modified to Better Balance the Resulting Compliance Burdens

If Treasury and the Service are committed to modifying the regulatory definition of “open account debt,” we respectfully submit that such modification should be made in a more narrowly tailored fashion in light of the compliance burdens and complexity associated with the approach in the Proposed Regulations. Specifically, as explained below, consideration should be given to the following: (a) increasing the dollar threshold to at least \$100,000; (b) providing additional quantitative tests to mitigate the harshness of the “cliff” effect in the Proposed Regulations; (c) requiring that the dollar amount of open account debt be tested no more frequently than the taxpayer maintains and updates its other books and records (rather than daily); and (d) treating certain kinds of debt as open account debt, regardless of amount.

¹⁰ As explained above, netting subsequent repayments against advances made earlier in the year does not appear to present any policy concern. Also as explained above, netting amounts between years also does not appear to raise any policy issues, because the basis adjustment and limitation rules have already been applied at the end of the preceding year(s).

¹¹ See, e.g., Reg. § 1.1361-1(l)(4)(ii)(A) (treating “any instrument, obligation, or arrangement” as a second class of stock only if a “principal purpose of issuing or entering into the instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders”).

¹² The above example of a possible anti-abuse rule is predicated upon our understanding of the government’s concerns with the fact pattern at issue in the *Brooks* case. It is not intended to imply what kinds of arrangements may be considered abusive or non-abusive in other contexts, but merely illustrates how the benefits of the open account debt netting rules could be denied in the particular fact pattern with which we believe the government is concerned, in lieu of imposing a broad new compliance regime on taxpayers.

¹³ See, e.g., Reg. § 1.197-2(h)(1) (stating the purpose of the section 197 anti-churning rules before providing an anti-churning anti-avoidance rule).

a. *Increase Amount of Threshold*

The preamble to the Proposed Regulations provides that the \$10,000 threshold was selected because it is the same threshold used for purposes of section 7872. Under section 7872, various tax consequences are imputed in the case of a below-market loan which is also a corporation-shareholder loan, an employment-related loan, or a gift loan. If a loan is subject to section 7872, interest expense and interest income are imputed to the borrower and lender, respectively, and the amounts of imputed interest not actually paid are treated in accordance with the relationship between the two parties. In general, no interest is imputed on a loan where the principal amount of the loan does not exceed \$10,000.¹⁴ This *de minimis* threshold was established because the additional federal tax that might result from the rigid application of the rules would be outweighed by the costs of compliance.¹⁵

However, in other cases, the application of section 7872 is limited where the amount of the loan does not exceed \$100,000. In these cases, the amount of interest imputed on a gift loan directly between individuals does not exceed the net investment income realized by the borrower from the use of the borrowed funds.¹⁶ This provision evidences the intent of Congress to limit both recordkeeping burdens and substantive tax consequences in the case of loans that may be ten times as large as the threshold established in the Proposed Regulations.

In the event that the Service chooses to retain a quantitative limitation, we recommend that the final regulations increase the limitation to at least \$100,000. Although any dollar limitation on what constitutes open account debt is arbitrary, increasing the threshold would mitigate the compliance burden on smaller businesses while allowing the Service to deny open account debt treatment in situations where the dollar amounts are more significant.

b. *Mitigate Harshness of “Cliff” Effect*

¹⁴ Section 7872(c)(2) provides the exception for gift loans between individuals, while section 7872(c)(3) provides a similar exception for compensation-related and corporation-shareholder loans. The exceptions are provided in separate provisions because separate and additional restrictions apply to the two categories of loans. The preamble to the Proposed Regulations specifically cites section 7872(c)(3) and the comparable provisions of Prop. Reg. § 1.7872-9.

¹⁵ We also are aware of another \$10,000 threshold in the S corporation area. Under the single-class-of-stock regulations, informal advances of \$10,000 or less are not treated as a second class of stock, even if they would otherwise have characteristics of equity under general federal tax principles. Reg. § 1.1361-1(l)(4)(ii)(B)(1). In order to qualify for this exception, they must be unwritten advances from a shareholder that do not exceed the threshold amount at any time during the taxable year of the corporation, must be treated as debt by the parties, and must be expected to be repaid within a reasonable time. The \$10,000 limitation is reasonable in the single-class-of-stock context because the rule is a safe harbor rather than the exclusive means of applying (or not applying) a debt-equity analysis. In the case of indebtedness that exceeds the \$10,000 threshold, an S corporation can still use the statutory safe harbor for straight debt (section 1361(c)(5)), the regulatory safe harbor for proportionately-held obligations (Reg. § 1.1361-1(l)(4)(ii)(B)(2)), and traditional debt-equity principles (Reg. § 1.1361-1(l)(4)(ii)(A)). These rules do not create the kind of compliance regime that is present in the running-daily-balance requirement under the Proposed Regulations.

¹⁶ Section 7872(d).

As drafted, the Proposed Regulations have a very significant “cliff” effect. In other words, advances that never exceed \$10,000 on any day during the taxable year are subject to the more easily administrable rules applicable to open account debt. In contrast, if the aggregate amount of advances from a shareholder reaches \$10,000.01 on just one day during the year, all subsequent advances and repayments are separately accounted for, even if the balance is reduced to less than \$10,000 for the remainder of the year. We believe that this can produce a harsh and unintended result. For example, assume that a shareholder must make a short-term advance to the corporation so that it can meet one payroll before obtaining more permanent bank financing. This advance could easily cause the running balance of the advances to exceed \$10,000 for just a few days out of the taxable year, even though the balance of the advances does not exceed \$10,000 for most of the year.¹⁷

A different fact pattern would also be subject to the Proposed Regulations, despite the fact that we do not consider it to invoke the same concerns that Treasury and the Service may have had with the facts of *Brooks*. Suppose that the balance of otherwise-qualifying open account debt is \$1 million at the beginning and the end of the taxable year. However, during the year it fluctuates between \$900,000 and \$1,100,000 as the result of advances and repayments, but the average balance remains at \$1 million for the entire year. We believe that, in this fact pattern, the entire amount should be treated as open account debt.¹⁸

If Treasury and the Service nonetheless decide to require “running daily balances,” the harsh effect of this rule could be ameliorated by adding a second prong to the threshold requirement based on the average of the daily balances. In other words, advances would fail to meet the requirements of open account debt only if *both* (1) the amount of the advances exceeded the applicable threshold amount on any day of the year *and* (2) the balance at the end of the year exceeded the average of the daily balances throughout the year.¹⁹

c. *Reduce Recordkeeping Burdens Associated with Daily Balances*

¹⁷ This fact pattern, of course, is the exact opposite of the *Brooks* facts, where the advances did not exist at all for a substantial portion of the taxable year, but peaked at the end of the year and were repaid at the beginning of the following year. It is hard to imagine an abuse that results from shareholder advances that are at their highest during the year but at their lowest at the end of the year. A shareholder’s ability to use corporate losses allocated to the shareholder is, after all, dependent on the loan balance at the end of the year.

¹⁸ We recognize that this component of our recommendation is inconsistent with the retention of any amount of threshold limitation, whether or not that threshold is increased to \$100,000 or some other number. We view this recommendation as an alternative means of avoiding the loss of open account debt status. For those taxpayers that do not choose to rely on this alternative average-balance test, the quantitative threshold would still be applicable. Thus, if an S corporation’s indebtedness to a shareholder never exceeded the applicable threshold amount during the year, such indebtedness would be treated as open account debt without regard to its average balance throughout the year.

¹⁹ References to “daily balances” in this part of our comments have been based on the assumption that the Regulations, when finalized, would continue the comparable requirement set forth in the Proposed Regulations. For the reasons set forth elsewhere in these Comments, we do not mean to suggest that a daily-balance requirement is desirable or appropriate.

Inasmuch as the vast majority of S corporations are small businesses (whether measured by assets, income, number of shareholders, or some other criterion), many S corporations and their shareholders will find it burdensome to maintain the “running daily balance” that would be required by Proposed Regulation section 1.1367-2(a)(2)(i).²⁰ Indeed, it is possible that some small businesses do not maintain and update general ledger accounts on a daily basis, but merely maintain them on a weekly or monthly basis. We recommend that the Proposed Regulations be modified so that the running balance should be tested no more frequently than the taxpayer maintains and updates its other books and records.²¹

There is some precedent for permitting corporations to maintain their records only on a monthly or other periodic basis. When a corporation joins or leaves a consolidated group, it is required to include its income or loss for only that portion of the taxable year in which it was a member of the group. The corporation is required to file a separate return for the portion of the taxable year for which it was not a member of this group, or to remain included in the consolidated return of any prior group of which it was a member for such portion.²² In order to achieve these objectives, it also is necessary to allocate the income of the member between the portion of the taxable year for which it is included in the consolidated return and the remaining portion of the year. In general, three alternative methods of making this allocation are provided. One such method, applicable when a corporation joins a consolidated group on any day other than the first day of the month, allows the corporation to close its books at the end of the month preceding the date on which it joins the group, and again at the end of the month in which it joins the group. It is then permitted to make a ratable daily allocation of its items of income or loss for the month.²³

Similarly, in the case of a partner who dies or otherwise disposes of his entire interest in a partnership, the partnership taxable year closes with respect to that partner.²⁴ The income or loss of the partnership for the entire taxable year must be allocated between the portion of its taxable year that ends on the date of disposition and the portion of the year that follows it. The income or loss of a partnership also must be determined for portions of a taxable year when a partner’s interest in the partnership changes during

²⁰ In this regard we note that the Paperwork Reduction Act discussion in the preamble to the Proposed Regulations estimates that only 250 record keepers would be affected by the Proposed Regulation and would be subjected to an average recordkeeping burden of one hour per year. This discussion specifically cited Prop. Reg. § 1.1367-2(a)(2)(i) as imposing the recordkeeping requirement. However, as noted above, that rule would require a shareholder of an S corporation to maintain a running daily balance of the advances and repayments in each year. Based on our experience, we believe that the number of record keepers, as well as the average annual recordkeeping burden for each shareholder, is significantly understated. If rigorously complied with, we believe the Proposed Regulations could require at least 250 hours of recordkeeping per year for a single taxpayer.

²¹ We recognize that the Proposed Regulations require the shareholder to maintain a record of this daily balance. In practice, we expect that a shareholder would rely on the S corporation to maintain these records. Accordingly, our comments are based on the judgment that a recordkeeping burden imposed on a shareholder of an S corporation is in essence being imposed on the S corporation itself.

²² Reg. § 1.1502-76(b)(1)(i).

²³ Reg. § 1.1502-76(b)(2)(iii).

²⁴ Section 706(c)(2).

the year. The Service has permitted certain partnerships to adopt conventions for the purpose of allocating income to partners in this latter instance, in order to avoid a need to maintain (or close) the books during a month.²⁵

d. Treat Certain Debt as Open Account Debt, Regardless of Amount

Certain kinds of debt should be treated as open account debt regardless of amount. For example, a shareholder-employee effectively makes a loan to an S corporation when the individual incurs expenses on behalf of the corporation that will subsequently be reimbursed under the corporation's policies generally applicable to all employees.²⁶ Such advances and repayments should be treated as open account debt regardless of the amounts involved. The Service could identify additional kinds of debt that always constitute open account debt in revenue rulings or revenue procedures.²⁷

In addition, there are many circumstances where open account debt, even large amounts thereof, does not implicate any of the issues that were of concern in the *Brooks* case. For example, situations where an advance is made and repaid during the course of a single taxable year do not raise any of the policy concerns that triggered the *Brooks* litigation. As discussed above, in that case, substantial amounts of open account debt that were in existence at the beginning of the year (and were used to absorb losses) were repaid *before* the offsetting advances against which they were netted were made. In fact, the abuse perceived in the *Brooks* case can never arise unless and until open account indebtedness basis actually is used to absorb losses in prior years. Thus, if Treasury and the Service impose a dollar threshold on open account debt, the threshold should not apply to debt unless it both existed at the beginning of the year and had been used to absorb prior losses. Such a rule would fully cover all of the situations with which we presume Treasury and the Service to be concerned, without imposing substantial additional compliance burdens on the large majority of taxpayers whose activities do not involve the type of abuse perceived to be raised by the *Brooks* decision.

²⁵ IR 84-129 (Dec. 13, 1984); see generally W. McKee, W. Nelson, and R. Whitmire, *Federal Taxation of Partners and Partnerships* ¶ 11.02[2][c] (3d Ed.).

²⁶ Prop. Reg. § 1.7872-5(b) also identifies several types of loans that are exempt from the application of section 7872. Although most of these exceptions would not apply to an S corporation, it is conceivable that a shareholder could maintain a deposit account with a bank that is either an S corporation or a qualified subchapter S subsidiary of an S corporation. An exemption modeled after Prop. Reg. § 1.7872-5(b)(2) also would seem appropriate.

²⁷ See Reg. § 1.338-8(d)(2)(v) (identification of assets not subject to carryover basis rule under section 338 consistency principles); Prop. Reg. § 1.7872-5(b)(15) (identification of loans not subject to section 7872 rules).