

CLIENT REPORT:

Open Account Debt Between S Corporations and Their Shareholders

Dear Client:

Final regulations have been released regarding the treatment of open account debt between S corporations and their shareholders. The regulations provide rules regarding the definition of open account debt, and adjustments in basis of any indebtedness of an S corporation to a shareholder for shareholder advances and repayments of loans to the S corporation. Since you have outstanding loans from your shareholders, you may be interested in the tax impact of these regulations.

In general, if a shareholder's basis in a debt owed to him or her by an S corporation has been reduced by pass-through losses from the S corporation, gain must be recognized by the shareholder if the corporation pays down the debt. The repayment of open account debt may result in ordinary income.

Regulations were originally proposed in response to a court ruling in which advances of open account debt by taxpayers to their closely held S corporations provided the taxpayers with basis to offset repayments of open account debt made by the corporation prior to each advance. Because the multiple advances by the taxpayers and repayments by the S corporations were treated as open account indebtedness, they were treated as a single indebtedness rather than separate indebtedness. The basis of the indebtedness was, therefore, computed by netting the advances and repayments at the close of the year. As a result, by restoring the basis in their debts, the advances that the taxpayers made to the S corporations shielded them from the realization of gain on debt repayments.

Under final regulations, open account debt cannot exceed \$25,000 per shareholder at the close of the year. For example, an S corporation with ten shareholders could have up to \$250,000 of open account debt as long as no single shareholder advances more than \$25,000. If the balance of the indebtedness at the end of the year exceeds \$25,000 for a shareholder, the entire amount is no longer considered open account debt and the shareholder may have to report income on repayments.

These regulations are important to your shareholders if their basis in their open account debt is reduced for prior pass-through losses. If you have questions regarding the tax treatment of the repayments of open account debt or taxpayer basis in general, we will be happy to assist you. Please call our office at your convenience.