

attributable to items constituting income in respect of a decedent. For the determination of items realized by an S corporation constituting income in respect of a decedent, see sections 1367(b)(4)(A) and 691 and applicable regulations thereunder. For the determination of the allowance of a deduction for the amount of estate tax attributable to income in respect of a decedent, see section 691(c) and applicable regulations thereunder.

[T.D. 8508, 59 FR 15, Jan. 3, 1994, as amended by T.D. 8852, 64 FR 71648, Dec. 22, 1999; 65 FR 12471, Mar. 9, 2000; 65 FR 16319, Mar. 28, 2000]

**§ 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.

(b) *Reduction in basis of indebtedness*—

(1) *General rule.* If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2) (B), (C), (D), and (E) (relating to losses, deductions, noncapital, non-deductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) *Termination of shareholder's interest in corporation during taxable year.* If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) *Multiple indebtedness.* If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) *Restoration of basis*—(1) *General rule.* If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any *net increase* in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, *net increase* with respect to a shareholder means the amount by which the shareholder's pro rata share of the

items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, non-deductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

(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.

(3) *Effect of election under section 1377(a)(2) or §1.1368-1(g)(2).* If an election is made under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under §1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition), this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder either terminates his or her interest in the corporation or disposes of a substantial amount of stock, whichever the case may be.

(e) *Examples.* The following examples illustrate the principles of §1.1367-2. In each example, the corporation is a calendar year S corporation. The lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

*Example 1. Reduction in basis of indebtedness.* (i) A has been the sole shareholder in Corporation S since 1992. In 1993, A loans S \$1,000 (Debt No. 1), which is evidenced by a ten-year promissory note in the face amount of \$1,000. In 1996, A loans S \$5,000 (Debt No. 2), which is evidenced by a demand promissory note. On December 31, 1996, the basis of A's stock is zero; the basis of Debt No. 1 has been reduced under paragraph (b) of this section

to \$0; and the basis of Debt No. 2 has been reduced to \$1,000. On January 1, 1997, A loans S \$4,000 (Debt No. 3), which is evidenced by a demand promissory note. For S's 1997 taxable year, the sum of the amounts specified in section 1367(a)(1) (in this case, nonseparately computed income and the excess deduction for depletion) is \$6,000, and the sum of the amounts specified in section 1367(a)(2) (B), (D), and (E) (in this case, items of separately stated deductions and losses, noncapital, nondeductible expenses, and certain oil and gas depletion deductions—there is no nonseparately computed loss) is \$10,000. Corporation S makes no payments to A on any of the loans during 1997.

(ii) The \$4,000 excess of loss and deduction items is applied to reduce the basis of each indebtedness in proportion to the basis of that indebtedness over the aggregate bases of the indebtedness to the shareholder (determined immediately before any adjustment under section 1367(b)(2)(A) and paragraph (b) of this section is effective for the taxable year). Thus, the basis of Debt No. 2 is reduced in an amount equal to \$800 (\$4,000 (excess) × \$1,000 (basis of Debt No. 2) / \$5,000 (total basis of all debt)). Similarly, the basis in Debt No. 3 is reduced in an amount equal to \$3,200 (\$4,000 × \$4,000 / \$5,000). Accordingly, on December 31, 1997, A's basis in his stock is zero and his bases in the three debts are as follows:

Debt	1/1/96 basis	12/31/96 reduction	1/1/97 basis	12/31/97 reduction	1/1/98 basis
No. 1 ..	\$1,000	\$1,000	\$0	\$0	\$0
No. 2 ..	5,000	4,000	1,000	800	200
No. 3 ..	.....	.....	4,000	3,200	800

*Example 2. Restoration of basis of indebtedness.* (i) The facts are the same as in *Example 1*. On July 1, 1998, S completely repays Debt No. 3, and, for S's 1998 taxable year, the net increase (within the meaning of paragraph (c) of this section) with respect to A equals \$4,500.

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals \$9,000. Thus, the basis of Debt No. 3 is restored by \$3,200 (the amount of the previous reduction) to \$4,000. A's basis in Debt No. 3 is treated as restored immediately before that

debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of \$1,300 (\$4,500 - \$3,200) is applied to restore the bases of Debt No. 1 and Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is \$5,800 (\$9,000 - \$3,200). The basis of Debt No. 1 is restored in an amount equal to \$224 (\$1,300 × \$1,000/\$5,800). Similarly, the basis in Debt No. 2 is restored in an amount equal to \$1,076 (\$1,300 × \$4,800/\$5,800). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

Original basis	Amount reduced	1/1/98 basis	Amount restored	12/31/98 basis
\$1,000	\$1,000	\$0	\$224	\$224
5,000	4,800	200	1,076	1,276

*Example 3. Full restoration of basis in indebtedness when debt is repaid in part during the taxable year.* (i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S \$1,000. S issues its note to C in the amount of \$1,000, of which \$950 is payable on March 1, 1998, and \$50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to \$900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is \$300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under § 1.1367-2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or \$1,000. Therefore, \$100 of the \$300 net increase is applied to restore the basis of the debt from \$900 to \$1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of \$200 increases C's basis in her stock.

*Example 4. Determination of net increase—distribution in excess of increase in basis.* (i) D has been the sole shareholder in Corporation S since 1990. On January 1, 1996, D loans S \$10,000 in return for a note from S in the amount of \$10,000 of which \$5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to \$8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals \$10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals \$0. During 1998, S also makes distributions to D totaling \$11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and

must be taken into account for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The \$10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the \$11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to \$0. See section 1368 and § 1.1368-1 (c) and (d) for the tax treatment of the \$1,000 distribution in excess of D's basis.

*Example 5. Distributions less than increase in basis.* (i) The facts are the same as in *Example 4*, except that in 1998 S makes distributions to D totaling \$8,000. On these facts, for 1998, there is a net increase with respect to D of \$2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of \$2,000 with respect to D for 1998, \$2,000 of the \$10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to \$10,000 (\$8,000 + \$2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of \$0 (\$0 + \$8,000 (increase in basis remaining after restoring basis in indebtedness) - \$8,000 (distribution)) and a basis in the note of \$10,000.

*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.

[T.D. 8508, 59 FR 16, Jan. 3, 1994, as amended by T.D. 9428, 73 FR 62202, Oct. 20, 2008; T.D. 9428, 73 FR 67389, Nov. 14, 2008; T.D. 9428, 73 FR 71545, Nov. 25, 2008]

### § 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 re-

vised 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.

[T.D. 9428, 73 FR 62203, Oct. 20, 2008]

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