



American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

November 13, 2012

Mr. Steven Miller
Acting Commissioner
CC:PA:LPD:PR (REG-134042-07)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on REG-134042-07, Basis of Indebtedness of S Corporations to Their Shareholders

Dear Acting Commissioner Miller:

The American Institute of Certified Public Accountants (AICPA) is pleased to provide comments on REG-134042-07, proposed regulations involving modification of Treas. Reg. § 1.1366-2 relating to basis of indebtedness of S corporations to their shareholders. In general, we express our support for the modifications made to Treas. Reg. § 1.1366-2 under the proposed regulations.

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125 year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We commend Treasury and the Internal Revenue Service ("Service") for their devoted effort to this regulation project. The proposed regulations will, when final, substantially reduce the uncertainty clouding the proper treatment of shareholder debt under section 1366 of the Internal Revenue Code (IRC). We appreciate and applaud the Service for adding more clarity and fairness in tax administration.

REG-134042-07 Is Consistent with Section 1366

REG-134042-07 clearly follows section 1366 which states that debt due from an S corporation to its shareholder shall be considered, in addition to stock basis, in determining the limitation on deductibility of losses passing through to the shareholder from the corporation. Section 1366 requires only that there be a debt between the corporation and its shareholder. The proposed regulations clearly state that a bona fide

debt from an S corporation to its shareholder, as determined under general tax principles, meet this sole statutory requirement.

The clear language of the proposed regulations, including the examples and accompanying preamble, should remove the judicially created, self-contradictory requirement that investing in an S corporation through a debt instrument must somehow leave the shareholder “poorer in a material sense” for having made the loan. Taxpayers and their advisors should no longer have to worry that a legitimate loan may be attacked for failing a requirement not in the Internal Revenue Code or regulations.

Recommendation for an Additional Example to Illustrate Bona Fide Indebtedness

The proposed regulations start with the statement that “the term basis of any indebtedness of the S corporation to the shareholder means the shareholder’s adjusted basis (as defined in Treas. Reg. § 1.1011-1 and as specifically provided in IRC section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder.” While the AICPA notes that Example (1) of the proposed regulations illustrates this point, we suggest an additional example be provided to illustrate that indebtedness can be bona fide indebtedness but still not provide basis for deduction of losses under IRC section 1366(d)(1)(B).

In general, the well-informed tax professional should be able to understand this point from a general tax principles perspective and the cross references provided by the proposed regulations in the quoted parenthetical. However, members of the AICPA’s S Corporation Tax Technical Resource Panel recently presented on the subject of basis in S corporation stock and debt at the IRS Nationwide Tax Forums during the summer of 2012. Based on this experience, we believe the proper understanding of basis is still an issue for many tax preparers. To help improve the understanding of basis, we suggest the following additional example:

Example: Bona Fide Debt Without Basis

KC Corporation is an S corporation. Shareholder K owns all of the stock. At the end of 2012, KC has accrued payroll and bonus payments to K, totaling \$25,000. The payment is in compliance with all provisions of local law, has the board of directors’ approval and is consistent with K’s employment contract. Thus, at the end of 2012, there is bona fide debt directly from KC to K. However, if K uses the cash method of accounting, and has not yet taken the \$25,000 into income, K has no basis in that debt. Therefore K cannot use this debt to support losses passing through from KC in 2012.

Treasury Should Permit Retroactive Application of the Regulations

As drafted, the proposed regulations are to be applied only to loan transactions entered into on or after the date of adoption as final regulations. The AICPA recognizes that, under IRC section 7805(b), Treasury cannot apply regulations retroactively to any statutory provision enacted after July 30, 1996. We further note that, under IRC section 7805(b)(7), Treasury is permitted to allow taxpayers retroactive application of a regulation through election. We strongly encourage the Treasury to permit retroactive application of these rules. The regulations add clarity to a statute that applies to all open years. The proposed regulations represent the correction of years of misunderstandings regarding loans from a shareholder to an S corporation. The resources of both taxpayers and the government should not be wasted needlessly disputing prior interpretations of a statute that applies as equally to open years as it does to future years. It can be argued that the statutory provisions addressed by REG-134042-07 predate July 30, 1996 and that this would permit Treasury to make these rules retroactive. We suggest that potential disputes be minimized or avoided by permitting retroactive application of the regulations by taxpayers.

Properly Treating the Contribution of a Shareholder Note to a Corporation

The preamble of the proposed regulations closes with a request for comment on how to properly treat the contribution of a shareholder note to a corporation where the corporation would, after such contribution, have the right to seek funds from the shareholder. The preamble suggests taking, for S corporations, an approach similar to one used for partnerships under Treas. Reg. § 1.704-1(b)(2)(iv)(d)(2) wherein the partner is given basis as payments are made on the note. This makes sense because, in that circumstance, the shareholder would have a zero basis in the contributed note.

The AICPA notes that this approach does not relate specifically to debt a corporation owes a shareholder. Rather this appears to be an extension of the section of the proposed regulations, specifically Treas. Reg. § 1.1366-2(a)(2)(ii), which states that guarantees of corporate indebtedness by a shareholder do not give rise to basis until actual payments are made by the shareholder on the corporate debt. We agree with the concept that one does not get basis until payment is made. However, we believe the contribution of a note to capital relates more to stock basis than debt basis as non-reciprocal transfers to a corporation have more in common with equity than debt. As the preamble states, this approach may be addressed in further regulation or in a revenue ruling. If Treasury or the Service considers addressing this issue through future guidance, we recommend consideration of, and consistency with, Treas. Reg. § 1.166-9(c) regarding contributions of debt to capital. The AICPA would also appreciate the opportunity to discuss the issue of contributions of shareholder debt to capital with the Service.

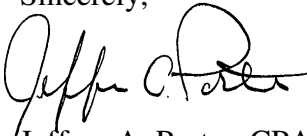
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In summary, the AICPA supports adoption of REG-134042-07 with the addition of one example and an opportunity for taxpayers to apply the regulations retroactively. We appreciate the Service's willingness to engage in dialogue aimed at improving tax administration for both the American taxpayers and their government. We look forward to continuing to work together on other issues in hopes of achieving similar results.

If you would like to discuss our comments on REG-134042-07 in more depth or have any questions, please contact me at (304) 522-2553, or jporter@portercpa.com; Christopher W. Hesse, Chair of the S Corporation Tax Technical Resource Panel at (509) 765-1281, or chris.hesse@cliftonlarsonallen.com; Benson S. Goldstein, AICPA Senior Technical Manager, at (202) 434-9279, or bgoldstein@aicpa.org.

Sincerely,



Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: The Honorable William Wilkins, IRS Chief Counsel
Mr. Curt Wilson, IRS Associate Chief Counsel (Passthroughs & Special Industries)
The Honorable Mark Mazur, Treasury Assistant Secretary (Tax Policy)
Ms. Lisa Zarlenga, Treasury Tax Legislative Counsel