imposing mandatory requirements governing generator relay loadability, thereby reducing the likelihood of premature or unnecessary tripping of generators during system disturbances. The Commission estimates that each of the small entities to whom the Reliability Standard PRC–025–1 applies will incur one-time compliance costs of $4,480 (i.e., the cost of re-setting any relays found to be out of compliance),[51] plus paperwork and record retention costs of $1,192 (one-time implementation) and $57.90 (annual ongoing).[52] Per entity, the total one-time implementation costs are estimated to be $5,672 (including paperwork and non-paperwork costs) and the annual ongoing costs are estimated to be $57.90.

29. The Commission does not consider the estimated costs per small entity to have a significant economic impact on a substantial number of small entities. Accordingly, the Commission certifies that this rule will not have a significant economic impact on a substantial number of small entities.

V. Environmental Analysis

30. The Commission is required to prepare an Environmental Assessment or an Environmental Impact Statement for any action that may have a significant adverse effect on the human environment.[53] The Commission has categorically excluded certain actions from this requirement as not having a significant effect on the human environment. Included in the exclusion are rules that are clarifying, corrective, or procedural or that do not substantially change the effect of the regulations being amended.[54] The actions taken herein fall within this categorical exclusion in the Commission's regulations.

VI. Document Availability

31. In addition to publishing the full text of this document in the **Federal Register**, the Commission provides all interested persons an opportunity to view and/or print the contents of this document via the Internet through the Commission's Home Page (*http://www.ferc.gov*) and in the Commission's Public Reference Room during normal business hours (8:30 a.m. to 5:00 p.m. Eastern time) at 888 First Street, NE., Room 2A, Washington, DC 20426.

32. From the Commission's Home Page on the Internet, this information is available on eLibrary. The full text of this document is available on eLibrary in PDF and Microsoft Word format for viewing, printing, and/or downloading. To access this document in eLibrary, type the docket number excluding the last three digits of this document in the docket number field.

33. User assistance is available for eLibrary and the Commission's Web site during normal business hours from the Commission's Online Support at 202–502–6652 (toll free at 1–866–208–3676) or email at *ferconlinesupport@ferc.gov,* or the Public Reference Room at (202) 502–8371, TTY (202) 502–8659. Email the Public Reference Room at *public.referenceroom@ferc.gov.*

VII. Effective Date and Congressional Notification

34. This Final Rule is effective September 22, 2014.

35. The Commission has determined, with the concurrence of the Administrator of the Office of Information and Regulatory Affairs of OMB, that this rule is not a ''major rule'' as defined in section 351 of the Small Business Regulatory Enforcement Fairness Act of 1996.[55] The Commission will submit the Final Rule to both houses of Congress and to the General Accountability Office.

By the Commission.

Issued: July 17, 2014.

Nathaniel J. Davis, Sr.,

Deputy Secretary.

[FR Doc. 2014–17229 Filed 7–22–14; 8:45 am]

BILLING CODE 6717–01–P

[51] These are non-paperwork related costs, which are not reflected in the burden described in the Information Collection Section above, and instead reflect the burden of re-setting relays in order to comply with the new requirements of PRC–025–1. Specifically, this figure reflects an estimated time of 8 hours per relay, assuming an average of 8 digital relays which will need to be re-set per small entity, at a cost of $70 per hour (the average of the salary plus benefits for a manager and an engineer, from Bureau of Labor Statistics at *http://bls.gov/oes/current/naics3_221000.htm* and *http://www.bls.gov/news.release/ecec.nr0.htm*).

[52] The one-time paperwork-related implementation cost estimate is based on a burden of 20 hours at $59.62/hour, and the annual record-keeping cost estimate is based on a burden of 2 hours at $28.95/hour. *See supra* at P 23 and n.44.

[53] *Regulations Implementing the National Environmental Policy Act of 1969,* Order No. 486, FERC Stats. & Regs. ¶ 30,783 (1987).

[54] 18 CFR 380.4(a)(2)(ii).

[55] *See* 5 U.S.C. 804(2).

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9682]

RIN 1545–BG81

Basis of Indebtedness of S Corporations to Their Shareholders

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to basis of indebtedness of S corporations to their shareholders. These final 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, which is determined under general Federal tax principles and depends upon all of the facts and circumstances. These final regulations affect shareholders of S corporations.

DATES: *Effective Date:* These final regulations are effective July 23, 2014.

Applicability Date: These final regulations apply to indebtedness between an S corporation and its shareholder resulting from any transaction occurring on or after July 23, 2014.

FOR FURTHER INFORMATION CONTACT: Caroline E. Hay, (202) 317–5279 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations contain amendments to the Income Tax Regulations (26 CFR part 1) under section 1366 of the Internal Revenue Code (Code). On June 12, 2012, the Treasury Department and the IRS published in the **Federal Register** (77 FR 34884) a notice of proposed rulemaking (REG–134042–07) (the proposed regulations) relating to when shareholders have basis in indebtedness that the S corporation owes to the shareholder (basis of indebtedness). The proposed regulations provide that basis of indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis in any bona fide indebtedness of the S corporation that runs directly to the shareholder. No requests to speak at the scheduled public hearing were received and the hearing was canceled. Comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, the proposed regulations are adopted

without substantive change by this Treasury decision, except for changes to the effective/applicability date of the regulations and minor clarifying revisions. The comments, which are available at www.regulations.gov or upon request, are discussed in this preamble.

Summary of Comments

1. Actual Economic Outlay

Courts developed the actual economic outlay standard, which requires that shareholders be made ''poorer in a material sense'' to increase their bases of indebtedness. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to his S corporation. See, for example, *Oren* v. *Commissioner,* 357 F.3d 854 (8th Cir. 2004), aff'g, T.C. Memo. 2002–172. Instead of applying the actual economic outlay standard, the proposed regulations provided that shareholders receive basis of indebtedness if it is bona fide indebtedness of the S corporation to the shareholder.

One commentator suggested that language be added to the regulations providing that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness. After considering this comment, the Treasury Department and the IRS believe that the proposed regulations clearly articulate the standard for determining basis of indebtedness of an S corporation to its shareholder, and further discussion of the actual economic outlay test in the regulations is unnecessary. Accordingly, the final regulations adopt the rule in the proposed regulations without change.

With respect to guarantees, however, the final regulations retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee. The final regulations make some minor changes to clarify the treatment of guarantees, including changing the heading to reiterate that the rule for guarantees is distinguished from the general rule adopting a bona fide indebtedness standard and moving the guarantee example after the examples illustrating the general rule consistent with the order of the regulations.

2. Regulation Examples and ''Circular Flow of Funds''

One commentator requested a change to the fact pattern presented in proposed regulations § 1.1366–2(a)(2)(iii), *Example 4.* In *Example 4,* a loan that originally was made by S1 to S2, two related S corporations wholly-owned by the same shareholder, is restructured to be a loan from the shareholder. The restructuring involved S1 distributing the debt to the shareholder and S2 being relieved of its liability to S1 so that S2 is only liable to the shareholder on the debt. The commentator recommended that *Example 4* not require that S2 be relieved of its liability to S1. As stated in the proposed regulations and finalized in these regulations, 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. Whether S2 is relieved of the original liability is an appropriate fact to consider in determining whether the transaction is a restructuring of a debt that results in a bona fide debt that runs directly from S2 to the shareholder. See, for example, Rev. Rul. 75–144 (1975–1 CB 277) (holding that a shareholder increases the shareholder's basis of indebtedness when the shareholder, who had guaranteed a liability of his S corporation, executed his own promissory note in full satisfaction of the S corporation's note to the bank, the bank relieved the S corporation of its liability, and the S corporation became obligated to the shareholder under the doctrine of subrogation). See also *Gilday* v. *Commissioner,* T.C. Memo. 1982–242 (holding that shareholders increased their bases of indebtedness when the shareholders gave a bank their notes, the bank canceled the S corporation's note to the bank, and the facts indicated that the S corporation became indebted to the shareholders, regardless of whether subrogation occurred under state law). Accordingly, this comment is not adopted.

This commentator also requested that an example be added to the regulations addressing a ''circular flow of funds.'' The commentator described a circular flow of funds as including a restructuring of a loan originally made by an S corporation owned by the shareholder to another S corporation owned by that shareholder (for purposes of this discussion, S1 and S2, respectively). This loan is restructured by one of two alternative methods: (i) S1 lends money to the shareholder, the shareholder lends that money to S2, and S2 uses that money to repay S1; or (ii) S2 repays S1, S1 lends money to the shareholder, and the shareholder lends that money back to S2.

The Treasury Department and the IRS recognize that there are numerous ways, including certain circular cash flows, in which an S corporation can become indebted to its shareholder. The proposed regulations included *Example 4* as an example of a loan originating between two related entities that is restructured to be from the S corporation to the shareholder to show that the debt need not originate between the S corporation and its shareholder, provided that the resulting debt running between the S corporation and the shareholder is bona fide. The Treasury Department and the IRS are aware, however, of cases involving circular flow of funds that do not result in bona fide indebtedness. See, for example, *Oren* v. *Commissioner,* 357 F.3d at 859 (purported loans, although meeting all the proper formalities, lacked substance); *Kerzner* v. *Commissioner,* T.C. Memo. 2009–76, at *5 (transaction lacked substance because money wound up right where it started and shareholder was merely a conduit through which the money flowed). Whether a restructuring results in bona fide indebtedness depends on the facts and circumstances. Because the Treasury Department and the IRS believe that the examples in the proposed regulations adequately illustrate that a restructuring of a debt that did not originate between the shareholder and the S corporation may result in basis of indebtedness as long as the resulting debt is bona fide, these final regulations do not contain additional examples.

Another commentator requested that an example be added to the regulations concerning a fact pattern in which bona fide indebtedness is present, but the shareholder has zero basis in that indebtedness. The commentator concluded that the shareholder would have zero basis of indebtedness in the shareholder's S corporation because the shareholder's basis in the debt is zero. The Treasury Department and the IRS believe that the regulations are clear that shareholders only increase their basis of indebtedness to the extent of the shareholder's adjusted basis (as defined in § 1.1011–1 and as specifically provided in section 1367(b)(2)) in that bona fide indebtedness of the S corporation that runs directly to the shareholder. If the shareholder's basis in the indebtedness is zero, then the shareholder's basis of indebtedness is increased by zero. As such, an additional example illustrating a zero

basis of indebtedness has not been added to the final regulations.

3. Section 1366(d)(1)(A) and Stock Basis

The preamble to the proposed regulations requested comments regarding the basis treatment when an S corporation shareholder or a partner contributes the shareholder's or partner's own note to an S corporation or a partnership. An S corporation shareholder does not increase his basis in the stock of his S corporation under section 1366(d)(1)(A) from a contribution of his own note. See Rev. Rul. 81–187 (1981–2 CB 167) (holding that a shareholder who (i) merely executed and transferred the shareholder's demand note to the shareholder's wholly owned S corporation, and (ii) made no payment on the note until the following year had a zero basis in the note until the following year when the shareholder made a payment on the note). The preamble to the proposed regulations described as one potential model § 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. One commentator recommended consideration of, and consistency with, § 1.166–9(c) (regarding contributions of debt to capital). Another commentator noted that courts have applied the ''actual economic outlay'' standard to determine when shareholders increase their bases in their S corporation stock. See, for example, *Maguire* v. *Commissioner,* T.C. Memo. 2012–160. This commentator requested that the final regulations provide that actual economic outlay does not apply to determinations of a shareholder's stock basis under section 1366(d)(1)(A). To expedite finalization of the proposed regulations, the scope of these final regulations is limited to basis of indebtedness. The Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance.

4. Potential Abuses From Shareholders Claiming Indebtedness Basis

One commentator stressed that, because S corporations are passthrough entities, allowing shareholders to claim S corporation losses if they have basis of indebtedness could allow shareholders to claim losses that are not bona fide. This commentator recommended that the IRS require that shareholders provide information to the IRS that all claimed S corporation losses are bona fide. The proposed regulations, however, do not affect the normal substantiation rules for the validity of claimed losses. See sections 6001 and 6037. See also *INDOPCO, Inc.* v. *Commissioner,* 503 U.S. 79, 84 (1992) (providing that ''an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer'' (quoting *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 593 (1943))). Accordingly, this comment is beyond the scope of these final regulations.

5. Effective and Applicability Date

Commentators also suggested that the Treasury Department and the IRS should permit retroactive application of the regulations. These commentators suggest that, pursuant to section 7805(b)(7), final regulations should allow taxpayers to elect to apply the rules in the regulations retroactively.

The proposed regulations provided that these regulations apply to transactions entered into on or after the regulations are published as final in the **Federal Register**. Upon further consideration of the applicability date, the Treasury Department and the IRS believe that allowing taxpayers to rely on these regulations will provide greater certainty for determining when shareholders have basis of indebtedness. As such, taxpayers may rely on these regulations with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

Special Analyses

It has been determined that these final regulations are 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 regulations. Because these 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, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Availability of IRS Documents

The IRS revenue rulings cited in this preamble are published in the Internal Revenue Cumulative Bulletin and are available from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402.

Drafting Information

The principal author of these regulations is Caroline E. Hay, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 * * *

■ **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 two sentences to the end of paragraph (f)(2).

The addition reads as follows:

§ 1.108–7 Reduction of attributes.

* * * * *

(f) * * *

(2) * * * Paragraph (d)(2)(iii) of this section applies on and after July 23, 2014. For rules that apply before that date, see 26 CFR part 1 (revised as of April 1, 2014).

■ **Par. 3.** Section 1.1366–0 is amended:

■ 1. By redesignating the entries in the table of contents for § 1.1366–2(a)(2), (a)(3), (a)(4), (a)(5), and (a)(6) as § 1.1366–2 (a)(3), (a)(4), (a)(5), (a)(6), and (a)(7), respectively, and adding new entries for § 1.1366–2 (a)(2) and (a)(2)(i) through (iii).

■ 2. By revising the heading in the table of contents for § 1.1366–5.

The additions and revisions 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) Special rule for guarantees.

(iii) Examples.

* * * * *

§ 1.1366–5 Effective/applicability date.

■ **Par. 4.** Section 1.1366–2 is amended by:

■ 1. Removing the language ''(a)(3)(i)'' in paragraph (a)(1)(i), and adding the language ''(a)(4)(i)'' in its place.

■ 2. 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.

■ 3. 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).

■ 4. Removing the language ''(a)(3)(i) and (ii)'' in newly designated 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 designated 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 designated paragraph (a)(4)(ii), and adding the language ''paragraphs (a)(1)(ii) and (3)'' in its place.

■ 7. Removing the language ''(a)(3)(i)'' and ''(a)(3)(ii)'' in newly designated 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 designated paragraphs (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 designated 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 designated 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) *Special rule for 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 of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's 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 of this chapter.

Example 2. 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 3. Loan restructuring through distributions. A is the sole shareholder of two S corporations, S1 and S2. In May 2014, S1 made a loan to S2. In December 2014, 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.

Example 4. Guarantee. A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, 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 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

* * * * *

■ **Par. 5.** Section 1.1366–5 is revised to read as follows:

§ 1.1366–5 Effective/applicability date.

(a) Sections 1.1366–1, 1.1366–2(a)(1), and 1.1366–2(b) through 1.1366–4 apply to taxable years of an S corporation beginning on or after August 18, 1998.

(b) Section 1.1366–2(a)(2) applies to indebtedness between an S corporation and its shareholder resulting from any transaction occurring on or after July 23, 2014. In addition, S corporations and their shareholders may rely on § 1.1366–2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

(c) Sections 1.1366–2(a)(3) through (7), and this section apply on and after July 23, 2014. For rules that apply before that date, see 26 CFR part 1 (revised as of April 1, 2014).

§ 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.

■ **Par. 7.** Section 1.1367–3 is amended by adding two sentences to the end of the paragraph to read as follows:

§ 1.1367–3 Effective/applicability date.

* * * Section 1.1367–1(h), *Example 5*(iii) applies on and after July 23, 2014. The rules that apply before July 23, 2014 are contained in § 1.1367–3 in effect prior to July 23, 2014 (see 26 CFR part 1 revised as of April 1, 2014).

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: May 27, 2014.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2014–17336 Filed 7–22–14; 8:45 am]

BILLING CODE 4830–01–P