Loans between your business and its owners

It's common for closely held businesses to transfer money into and out of the company, often in the form of a loan. However, the IRS looks closely at such transactions: Are they truly loans, or actually compensation, distributions or contributions to equity?

Loans to owners

When an owner withdraws funds from the company, the transaction can be characterized as compensation, a distribution or a loan. Loans aren't taxable, but compensation is and distributions may be.

If the company is a C corporation and the transaction is considered a distribution, it can trigger double taxation. If a transaction is considered compensation, it's deductible by the corporation, so it doesn't result in double taxation — but it will be taxable to the owner and subject to payroll taxes.

If the company is an S corporation or other pass-through entity and the transaction is considered a distribution, there's no entity-level tax, so double taxation won't be an issue. But distributions reduce an owner's tax basis, which makes it harder to deduct business losses. If the transaction is considered compensation, as with a C corporation, it will be taxable to the owner and subject to payroll taxes.

Loans to the business

There are also benefits to treating transfers of money from owners to the business as loans. If such advances are treated as contributions to equity, for example, any reimbursements by the company may be taxed as distributions.

Loan payments, on the other hand, aren't taxable, apart from the interest, which is deductible by the company. A loan may also give the owner an advantage in the event of the company's bankruptcy, because debt obligations are paid *before* equity is returned.

Is it a loan or not?

To enjoy the tax advantages of a loan, it's important to establish that a transaction is truly a loan. Simply calling a withdrawal or advance a "loan" doesn't make it so.

Whether a transaction is a loan is a matter of intent. It's a loan if the borrower has an unconditional intent to repay the amount received and the lender has an unconditional intent to obtain repayment. Because the IRS and the courts aren't mind readers, it's critical to document loans and treat them like other arm's-length transactions. This includes:

- Executing a promissory note,
- Charging a commercially reasonable rate of interest — generally, no less than the applicable federal rate,
- Establishing and following a fixed repayment schedule,
- Securing the loan using appropriate collateral, which will also give the lender bankruptcy priority over unsecured creditors,
- Treating the transaction as a loan in the company's books, and
- Ensuring that the lender makes reasonable efforts to collect in case of default.

Also, to avoid a claim that loans to owner-employees are disguised compensation, you must ensure that they receive reasonable salaries.

Please contact Ceschini, CPAs at (631) 474-9400 for more information about this topic and other tax and business developments – such as new IRS regulations and court decisions.