



# STRATEGIES FOR Success

## LOANS: CORPORATIONS AND SHAREHOLDERS

*Will the real loan  
please stand up?  
Don't let the IRS  
question lending  
transactions  
between you and  
your company*

More and more cases are being documented of business loans being made from the corporation to the shareholder or from the shareholder to the corporation. Many of these loans are undocumented, don't call for payments, don't provide for interest and probably won't ever be repaid. If this happens to be the scenario for your company, the IRS probably will question whether these really are loans.

If these "loans" ultimately are reclassified by the government as something other than loans, the tax repercussions can be rather serious. For example:

- If a C Corporation makes such a "loan" to a shareholder, the loan can be considered a dividend and the corporation gets no deduction, while the shareholder is taxed on the full amount of the loan.
- If the shareholder makes a "loan" to a C Corporation, the loan can be considered a contribution to capital for the corporation and repayment can be considered a distribution of earnings, which is a dividend to the shareholder with no deduction for the corporation.
- If an S Corporation makes a "loan" to a shareholder, it can be considered a distribution from the accumulated adjustment account (AAA) up to the limit of that account, then it becomes a return of basis and after that it's a capital gain.
- If the shareholder is not being adequately compensated, the loan may be reclassified as additional compensation,

subject to payroll taxes.

- If the shareholder makes a "loan" to an S Corporation, the loan can be reclassified as a second class of stock, which thereby disqualifies the S election.

Below are the factors most often considered in deciding if the payments between shareholders and corporations really are loans, or if they should be reclassified as dividends or contributions to capital.

1. Whether enforceable promissory notes were issued.
2. If interest were paid or accrued.
3. Did the borrower in fact repay or attempted to repay the advances.
4. Whether security was given for the loan.
5. The extent to which the shareholder controls the corporation.
6. Was there a set maturity date.
7. Earnings and dividend history of the corporation.
8. Was the borrower in a position to repay the advances.
9. How large are the advances and does a ceiling exist that limits the loan amount.
10. How the shareholder and corporation recorded the loan on their books and records.

There are various other factors to consider, and analyzing each one is necessary to determine the true character of the "loan."

**To learn more about loans between corporations and shareholders, consult your Fiducial Business Services representative.**

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