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Will Your Shareholder Loan Stand Up to IRS Scrutiny?

Borrowing from your closely held corporation may seem simple, but without proper planning it can be painfully expensive. The IRS often reviews such loans to determine if they are merely disguised cash withdrawals. For example, the IRS may treat an improperly structured loan as a dividend, which would be taxable to you and not deductible by the corporation.

The IRS generally asks the following questions when evaluating a corporation loan to one of its shareholders:

- Does the borrowing shareholder control the corporation? The greater the degree of control, the more closely the loan will be scrutinized.
- Did the corporation require adequate collateral for the loan?
- Is the borrower financially able to repay the loan within a reasonable time period?
- Did the shareholder sign a promissory note with an appropriate interest rate, a reasonable repayment schedule, and a fixed maturity date?
- Has the borrower been making the required payments on schedule?
- If the borrower missed one or more payments, has the corporation tried to collect?

When a corporation lends money to one of its shareholders, the transaction should be structured as though it were being made to an unrelated party - a stranger. The borrower should sign a promissory note that includes payment terms and a final due date. At a minimum, interest should be charged at the IRS statutory rate in effect at the time of the loan. Requiring adequate collateral will be regarded as a favorable indicator by the IRS although it is not mandatory. The terms of the loan should be voted on by the Board of Directors, and the details should be entered into the corporate minutes. The borrower should make payments according to the agreed-upon schedule.

Since circumstances are different for each corporation and each shareholder, you should always consult your accountant before transferring money from your company. If we can be of assistance, call us.