Taking Cash Out: Shareholder Loans
How Shareholders Can Avoid Taxes on Loans from Their Corporations

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It's not an uncommon occurrence. An IRS auditor spots funds moving from a corporation to its owner. The checks are labeled "loans." However, there are no formal loan agreements, no indication that interest was charged, and no evidence that there has been any repayment. This raises a red flag for the auditor. In fact, it raises two red flags:

1. Were the checks bona fide loans or disguised dividends?
2. If the checks were bona fide loans, is the failure to charge interest a taxable event under the tax code's below-market loan provision [IRC Sec. 7872].

Documentation Counts

To avoid problems, adopt the "walk-like-a-duck, quack-like-a-duck" strategy: Even though the shareholder may have truly intended the checks to be loans, the best way to convince the IRS of that fact is to follow all of the formalities, just as if the corporation were loaning funds to a stranger. Things like promissory notes, repayment schedules, a reasonable interest rate charge, and a track record of repayments-even if not perfect-can go a long way toward persuading an IRS auditor that the parties intended the payments to be loans.

Loans vs. Dividends

The tax code provides that a distribution made by a corporation with respect to its stock is a taxable dividend to the extent of a corporation's earnings and profits [IRC Sec. 301, 316]. Whether a shareholder's withdrawals from a corporation are loans or dividend distributions depends on whether, at the time of the withdrawals, the shareholder intended to repay the amounts received and the corporation intended to require repayment [Miele, 56 T.C. 556 (1971)]. On that issue, a shareholder's statement that he or she intended to repay can be considered. But the shareholder's statement won't prove the withdrawals were loans, especially in the case of a closely held corporation, unless it is supported by other facts indicating an arms-length transaction.

The following factors have been used by courts to determine whether a corporate advance is a loan or a dividend:

1. The extent to which the shareholder controls the corporation.
2. The earnings and dividend history of the corporation.
3. The size of the advances.
4. Whether a ceiling existed to limit the amounts advanced.
5. Whether or not security was given for the loan.
6. Whether there was a set maturity date and repayment schedule.
7. Written evidence of a loan, such as an interest-bearing note.
8. Whether the corporation ever took steps to enforce repayment.
9. Whether the shareholder was in a position to repay the loan.
10. Whether there was any indication of attempts to repay by the shareholder (e.g., Nahikian T.C. Memo. 1995-161].

Case in Point

The *Epps* case (T.C. Memo. 1995-297) is a good example of how these factors are weighed. John Epps and his wife were the sole shareholders of EMSC Inc. From the time of EMSC's incorporation, John routinely withdrew corporate funds from EMSC for his personal use. These withdrawals were recorded on EMSC's books as stockholder advances, and as "'Other Assets'" on the company's financial statements. Epps never executed any promissory notes in favor of EMSC or secured any of the withdrawals with collateral. No specific schedule for repayment was ever established. No interest was charged on the amounts Epps withdrew, and EMSC never placed a limit on the amounts available to him.

However, Epps did make repayments by crediting year-end bonuses awarded by EMSC against his outstanding stockholder advances account. And, after the IRS started an audit of EMSC, Epps transferred title to the condominium in which he lived to EMSC, in return for which $80,000 was credited to the stockholder advances account.

The Tax Court said that the "absence of the standard indicia of indebtedness weighs on the side of a constructive dividend determination." There were no written agreements or notes evidencing the loans. No interest was charged on the amounts withdrawn. There was no ceiling limiting the amount Epps could withdraw. There was no security for the loans, no set maturity date, and no efforts by the EMSC to enforce repayments.

EMSC did not pass a corporate resolution authorizing the advances, and there were no corporate minutes substantiating any formal action taken by the corporation's board of directors. Epps placed a great deal of emphasis upon EMSC's accounting for the withdrawals as loans on its books as evidence of intent to repay the advances. The court responded that while this factor did work in Epps' favor, by itself it was no enough to prove the existence of bona fide loans.

The Tax Court also did not give much weight to Epps' "repayments." The court determined that EMSC's declaration of year-end bonuses and Epps' use of those bonuses to credit his loan account were simply bookkeeping entries designed to give his withdrawals "the color of loans." The court was also dismissive of the condo transfer to EMSC. Since the transfer occurred after the IRS began its audit of EMSC, the court did not find it to be "persuasive evidence of an intention to create a real debt."

S Corporations. While the loan-or-dividend issue usually arises in the context of a C corporation, it can also be a problem for owners of S corporations (e.g., Jones, T.C. Memo, 1997-400). If payments from an S corporation are distributions, and not loans, the amount distributed reduces the shareholder's basis for his or her stock. If the amount exceeds the basis, the excess is treated as payment in exchange for the stock (i.e., capital gain) [IRC Sec. 1368(b)(2)].

Below-Market Loans

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the "applicable federal rate" (AFR) [IRC Sec. 7872(e)]. The IRS publishes the AFR each month in the Internal Revenue Bulletin (available on the IRS Web site at www.irs.gov). The rates can also be obtained at IRS offices.

The tax code recasts a below-market loan as a two-step transaction:

1. A loan from the lender at the AFR.
2. A payment from the lender to the borrower equal to the amount of the foregone interest which the borrower then uses to repay the lender [IRC Sec. 7872(a)(1)].

The foregone interest for any period is the difference between the interest that would have been charged at the AFR and the interest (if any) that was actually charged [IRC Sec. 7872(e)(2)].

The tax treatment of step (2) depends on the substance of the transaction. In the case of a loan from a C corporation to a shareholder who is a shareholder, the deemed payment from the corporation is a dividend, which is generally taxable to the shareholder and not deductible by the corporation. In the case of an S corporation, the deemed payment would be a taxable distribution to the extent it exceeds the shareholder's basis for his or her stock.

The deemed interest payment by the shareholder could be deductible (e.g., business purpose for loan) or nondeductible (e.g., personal loan), depending on the use of the proceeds. The corporation reports both the actual and foregone interest as income.

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If the loan is payable on demand, the deemed payment to the shareholder and the deemed repayment to the corporation are treated as if they occur annually [IRC Sec. 7872(a)(2)]. In the case of a term loan, the deemed payment to the shareholder occurs once, when the loan is made. The deemed payment is equal to the loan amount less the present value of all payments due under the loan [IRC Sec. 7872(b)(1)]. The deemed repayment by the shareholder is spread out over the term of the loan under the original issue discount rules of IRC Sec. 1272 [IRC Sec. 7872(b)(2). In other words, the shareholder will realize all of the dividend income upfront, while the interest expense is deemed paid over time.

The below-market loan provision does not apply to loans of $10,000 or less between a shareholder and a corporation if tax avoidance is not a principal purpose of the interest arrangement [IRC Sec. 7872(c)(2)]. The shareholder of a closely held corporation may, of course, also be an employee. And the below-market loan rules also apply to loans from an employer to an employee [IRC Sec. 7872(c)(1)(B)].

However, with an employer-employee loan, the deemed payment from the employer is treated as compensation (deductible by the employer). The IRS has proposed regulations that provide that a loan from a closely-held corporation to a shareholder-employee is presumed to be corporation-shareholder loan-and not an employer-employee loan-in certain cases. The presumption applies if the shareholder-employee owns directly or indirectly one or more of the following:

- More than 5 percent of the total voting power of all classes of stock entitled to vote.
- More than 5 percent of the total number of shares of all other classes of stock.
- 5 percent [*see note following*] of the total value of shares of all classes of stock (including voting stock) of the corporation 4 [Prop. Reg. 1.7872-4(d)].

Editor's Note. *The language of the third item in this list breaks from the pattern of the first two items and does not include the modifier, "More than." As this article is posted, we do not find further clarification on this third category. Possibly the drafters dropped "More than" in error, and later guidance will be welcome.* This presumption (that loans from closely-held corporations to shareholder-employees are corporation-shareholder loans) can be overcome if a shareholder provides "clear and convincing evidence that the loan is made solely in connection with the performance of services." For example, if loans are also made to employees who are not shareholders, but no loans are made to shareholders who are not employees, this would tend to indicate that the loans are employment-related.

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