Take care when you borrow or lend money to your company

It's not unusual for owners of closely held businesses to move money into and out of the company for various purposes. If the company is having trouble meeting its obligations, for example, an owner might advance personal funds to keep it afloat. Or if an owner is facing unusual personal expenses, he or she might withdraw funds from the business to cover them.

There are significant tax advantages to characterizing these transactions as loans. But to enjoy those advantages, you must treat advances and withdrawals as bona fide loans and document them as such.

Why loans are preferable

When an owner withdraws funds from a company, the transfer can be characterized as compensation, a distribution or a loan. Loans aren't taxable, but compensation and distributions, of course, are taxable.

And if the company is a C corporation, distributions trigger double taxation — in other words, corporate earnings are taxed once at the corporate level and again when they're distributed to shareholders (as dividends). Compensation is deductible by the corporation, so it doesn't result in double taxation. (But it is subject to payroll taxes.)

If the company is an S corporation or other pass-through entity, there's no entity-level tax, so double taxation isn't an issue. Still, loans are advantageous because:

1. Compensation is taxable to the owner (and incurs payroll taxes), and
2. In addition to being taxable, distributions reduce an owner's tax basis, making it harder to deduct business losses.

There are also advantages to treating advances from owners as loans. If they're treated as contributions to equity, any reimbursements by the company will likely 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.

How to ensure loan treatment

It's important to establish that an advance or withdrawal is a loan. If you don't, and the IRS decides that a payment from the company is really a distribution or compensation, you (and, possibly, the company) can end up owing back taxes, penalties and interest.

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.

Unfortunately, even if you intend a transaction to be a loan, the IRS and the courts aren't mind readers. So it's critical to document loans and treat them like other arm's-length transactions. Among other steps, you should:

- Execute a promissory note,
- Charge a commercially reasonable rate of interest — generally, no less than the applicable federal rate (AFR),
- Establish and follow a fixed repayment schedule,
- Secure the loan using appropriate collateral (this will also give the lender bankruptcy priority over unsecured creditors),
- Treat the transaction as a loan in the company's books, and
- Ensure that the lender makes reasonable efforts to collect in case of default.

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

Actions speak louder than words

Calling an advance or a withdrawal a "loan" doesn't make it so. To avoid an IRS challenge, put it in writing and make sure your actions are consistent with the desired treatment. Consult with your attorney for more information.

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