

Dangers in Shareholder Loans Continue

Loans between shareholders and closely held corporations are subject to special tax scrutiny and if not properly documented, can produce adverse tax results.

Loans from corporations to shareholders are the subject of an IRS Audit Technique Guide that stresses the possibility of treating them as distributions and therefore taxable as dividends. The IRS also continues to vigorously litigate the status of losses from shareholder loans to closely held corporations that turn out to be uncollectible. Either way, loans from or loans to, these arrangements must meet certain minimum standards. Here's a list of the most important ones.

- Loans must be evidenced by a written unconditional promise to pay.
- Loans must be due on demand or on a stated due date.
- A rate of interest must be stated or determinable by reference to a published rate.
- The borrower must be creditworthy.
- Payments of principal and interest must be commercially reasonable (payments, not made for years, while interest accrues, do *not* meet the standard).
- A source of repayment other than future income should be clearly identified and a collateral interest established.

Protecting the classification of a loan can mean the difference between ordinary loss and capital loss treatment when a shareholder loan to a corporation cannot be repaid. Going the other way, payments to a shareholder that are not well documented as loans can be reclassified by the IRS as distributions -- taxable dividends or distributions in excess of basis taxable as capital gains. Either way, these are bad outcomes for the individual shareholder.

Now is the time to clean up loan documentation and start making regular payments of principal and interest. In some cases, it may be advisable to borrow from a bank and pay off shareholder loans for a period of two or three months. That would be good evidence that the amount was a bona fide loan and that the shareholder is creditworthy.

We can assist you with proper loan documentation and can help you protect your transactions from IRS attack. Call for an appointment to discuss the specifics of your shareholder loans.