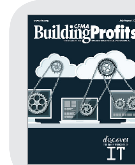

Copyright © 2016 by the Construction Financial Management Association (CFMA). All rights reserved. This article first appeared in *CFMA Building Profits* (a member-only benefit) and is reprinted with permission.

BY RICH SHAVELL

Tax Implications of Debit Shareholder Loans

Why would a shareholder of a closely held construction company owe the company money and have it show as a debit loan/receivable on the company books? Let's consider some possible explanations:

- The shareholder is using the corporate checkbook for personal expenses that are reflected as a loan;
- The shareholder needs to borrow funds for acquisition of property and is using the company for the down payment. It may be business-related: For example, the down payment could be needed to purchase an owner-occupied property in which the construction company is located and is now paying rent; or
- At the end of the year, distributions are reclassified to a receivable to ensure there were not distributions in excess of basis taxable to the shareholder.

Regardless of the reason, money has left the company and a debit shareholder loan must now be addressed. This article will cover the tax issues associated with such loans, focusing on implications to S corporations and their shareholders.

Determine If the Receivable Is a Loan

The main issue to consider is whether the shareholder receivable is truly a loan, which has several tax implications. If it's not truly a loan, the IRS could argue one of the following:

1) Are the amounts actually additional taxable compensation? This would result in an increased deduction to the company and increased ordinary taxable income to the owner-shareholder subject to employment taxes.

2) Are the amounts actually a constructive dividend? Here, the result is potential taxability as ordinary income or capital gain.

If the debit loan account is in fact a loan for tax purposes, then the IRS could still argue that the interest that has yet to be charged (or paid) for below-market rate loans should be subject to additional taxable income.

Key Factors

Numerous cases[1] debate if shareholder advances are bona fide loans. Courts view this as a factual question that should be determined based on all of the surrounding facts and circumstances: "For the disbursements to constitute loans, there must have been, at the time of the transfers, an unconditional intention on the part of the transferee to repay them, and an unconditional intention on the part of the transferor to secure such repayment."[2]

To determine if there is intent to repay the shareholder advances, courts analyze several key factors, including:

Shareholder-Corporation Relationship[3]

- How much control does the debtor-shareholder have in the corporation? Are the loans arms-length transactions?
- Does the debtor-shareholder have the ability to repay the advances without access to additional corporate funds?
- Has the corporation enforced collection of the receivable?

Formalities & Terms[4]

- Is there a formal note executed by the debtor-shareholder and the entity?
- Is there a date certain when the loan matures?
- Is interest being charged, and if so, is any being paid?
- Is there any collateral for the loan?
- Is there a schedule of requisite payments, and have any been made?

Dividend Issues[5]

- At the time of the loan, does the corporation have accumulated prior S corporation earnings, which may be indicative of a constructive dividend distribution rather than a bona fide loan?
- Does the corporation's history (or lack of history) for paying dividends indicate that the advances could be dividend distributions rather than loans?
- For S corporations that were previously C corporations, are amounts reclassified as distributions dividends of prior C corporation earnings subject to ordinary income tax?

Reasonable Compensation[6]

If the S corporation shareholder is not paid adequate and reasonable compensation, then it's possible that all or a portion of the advances are actually wages not yet recognized. Here, employment taxes may come into play. Moreover, if the S corporation is already in a loss position for which there is no basis for the shareholder to take the increased loss, then income at the shareholder level occurs with no corresponding benefit of the entity-level deduction for the increased wages. These additional wages could also affect the company's pension plan or workers' comp premiums.

Financial Statement Reporting

Although not always a deciding factor, an ancillary issue that the courts sometimes consider is how the advances are reported on the taxpayer's financial statements. For example, the fact that a construction company's surety considered advances by the corporation would later be repaid by the shareholder was viewed positively in one such case.[7] In another case where financial statements were provided to a state agency, the advances were considered as evidence but were inconclusive.[8]

The courts have also have considered financial data supplied to taxpayers' banks. In a case where the shareholder submitted a personal financial statement of position with an application for a bank loan but did not include the loan among the shareholder's personal liabilities, the court determined that advances were not a loan.[9]

In another case, the financial statement reflected certain advances as a demand note at a specific interest rate, but no actual note existed to support the statement. The court considered the false description to be nothing more than unsupported bookkeeping entries.[10]

Interest

A bona fide loan always has associated interest. If the IRS deems the interest rate too low or if no interest is being charged, then the loan is considered a below-market loan.[11] The IRS publishes interest rates for different types of loans on a monthly basis. Generally, these rates are based on the term and type of loan at issue. This rate is the lowest Applicable Federal Rate (AFR) that should be applied to the loan.[12]

The effect of a below-market rate loan is twofold:

1) Interest must be computed and treated as having been paid by the borrower to the lender; and

2) The portion of interest, if any, that has not actually been paid is potentially treated as a taxable event by the IRS upon audit (e.g., a gift, compensation, or a dividend, depending on the relationship between the parties).

Original issue discount (OID) may be imputed when an interest rate is at an acceptable rate but interest is not being paid.[13] This computation depends on whether the loan is a demand or a term loan. A demand loan is either due and payable upon demand of the lender at any time, or it has no maturity.[14]

There are certain exceptions to imputing interest. The main exception is for ***de minimis*** loans, where the aggregate loans outstanding between the corporation and the shareholder does not exceed $10,000.[15]

Other exceptions generally involve loans related to installment contracts or other transactions involving the sale of property, such as:[16] demand loan issued in exchange for property; debt instrument issued for publicly traded property; or debt instrument issued for personal-use property.

For below-market rate loans, computations can become complex for imputed interest and, when applicable, OID. There are various scenarios to consider, such as:

- When a blended annual rate can be applied;[17]
- Demand loans with stated interest at or above AFR;
- Computing imputed transfer and OID;[18]
- Computing forgone interest for a below-market demand loan;
- Short period computations;[19]
- Computations for loans with increasing balances; and
- Computations for loans with decreasing balances.[20]

Practical Reductions

In many cases, shareholder loans in S corporations can be eliminated. When evaluating year-end tax results, certain transfers to shareholders initially treated as dividend distributions may have been reclassified as loans because the S corporation shareholder did not have sufficient basis to report dividend distributions on a tax-free basis.

In a later year when sufficient taxable income is passed through to the shareholder – an increase in basis – the owner-shareholder may choose to reclass the remaining balance of the loan as a dividend distribution.

Under certain circumstances, the remaining balance in the shareholder loan account could be adjusted and included in the shareholder's current year compensation. This would be advisable when additional shareholder compensation is necessary or even advantageous.

As noted previously, when basis is adequate, an S corporation shareholder may also choose to eliminate a portion or the entire remaining balance of the debit shareholder loan by reclassifying the loan balance against dividend distributions.

However, simply awaiting a profitable tax year at which time the company records journal entries to reduce or eliminate the debit shareholder loan may be risky. A consistent practice of temporary loans that are later being adjusted does not assist in proving to the IRS the intent to pay back the debt at the time of the advances.

Summary

Debit shareholder loans enable shareholders of closely held businesses to utilize company funds for various purposes. And, as much as the CFM or outside CPA might advise against such loans being left open at year-end or at interim reporting dates, they are periodically necessary.

CFMs should ensure that advances and loans to shareholders are properly documented with a formal note, an appropriate rate of interest, repayment terms, maturity date, and if feasible, security.Importantly, the CFM should then ensure that the terms are adhered to until the loan can be fully paid down or, in some cases, effectively adjusted to zero. ■

Endnotes

1. The following cases serve as overview examples: Shea, Richard v. U.S., (1982, DC AL) 51 AFTR 2d 83-658; Kamil F. Gowni, et al. v. Commissioner, T.C. Memo 2004-154; Smith, Robert (1980) T.C. Memo 1980-15.
2. Baird v. Commissioner, T.C. Memo 1982-220 citing Saigh v. Commissioner, 36 T.C. 395.
3. Baird v. Commissioner, 25 T.C. 387 (1955).
4. Baird v. Commissioner, T.C. Memo 1982-220.
5. Miller v. Commissioner, T.C. Memo 1980-445.
6. Glass Blocks Unlimited v. Commissioner, T.C. Memo 2013-180.
7. Gamble Construction Co., Inc. v. Commissioner, T.C. Memo 1978-404.
8. Granzotto v. Commissioner, T.C. Memo 1971-106.
9. Genito, James, et al. v. U.S. (D.N.J. 1980).
10. Epps v. Commissioner, T.C. Memo 1995-297.
11. IRC § 7872(e)(1).
12. IRC § 7872(e)(2) citing 1274(d).
13. IRC § 7872(b)(2)(A).
14. IRC § 7872(f)(5).
15. IRC § 7872(c)(3).
16. IRC § 7872(f)(8).
17. Prop. Reg. § 1.7872-13(a).
18. Prop. Reg. § 1.7872-7.
19. Prop. Reg. § 1.7872-12.
20. Prop. Reg. § 1.7872-13(c).

RICH SHAVELL, CPA, CVA, CCIFP, is President of Shavell & Company, P.A., a full service CPA and consulting firm specializing in serving contractors based in south Florida.

Rich has testified on issues affecting contractors before Congress and the IRS. He is a past winner of the South Florida Business Journal award for CPAs in construction, real estate, and tax categories.

Rich joined CFMA in 1990 and has served the association in various capacities. He was Chair of CFMA's Tax and Legislative Affairs Committee, is a current member of CFMA's Emerging Issues Committee, and serves on the Board of the South FL Chapter of CFMA.

Phone: 561-997-7242
E-Mail: info@shavell.net
Website: www.shavell.net