

Money: To and From Your Company

For Owners, Their Families, and Executives

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- **8 Steps to Protect Yourself and Business**
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Money To and From Your Company

Every now and then, there is a subject that is so important that **every** business owner, executive, and accountant should review it promptly. *This is one of them.*

If you, employees, family members, board members, and affiliated companies are *not* now in tax and legal compliance with the regulations and requirements explained in this **Resource Report**, work with your accountant and lawyer to implement the necessary changes.

Since many of the ideas apply to most forms of business (e.g., C and S corporations, partnerships, and limited liability companies), you will want to save this Report for future reference and share the information with your accountant and lawyer. *Bottom line:* You don't want your loans or advances from the company reclassified by the IRS as compensation or a dividend because the tax impact is severe.

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It seems simple enough. You need cash and the business has surplus money so you borrow from the company. *What you should have done:* Consulted with your accountant/lawyer in checking your company's charter/bylaws and state law, both of which can prohibit or limit personal loans from company funds to stockholders, partners, board members, employees, family members, and affiliated businesses owned by the company or its stockholders.

The risk: The IRS could decide that the transfer of money from the company to you is *not a loan* and reclassify it as taxable compensation to you or, a dividend, which makes the loan amount still taxable income to you but not tax deductible by the company.

That's the big trap when you borrow from your company. We don't mean to say you can't ever arrange a personal loan from your company because the attrac-

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tion of accessing surplus company funds is obvious, but if you do, *do it correctly*. Whenever the line between personal and business dealings gets fuzzy, as it does in personal loans from company funds, the IRS can be expected to step in and start drawing its own lines. And that can cost you plenty in additional taxes.

8 Steps to Protect Yourself and the Business

To take away the IRS' ammunition in reclassifying a loan, make sure there's no question that *the transaction is a valid loan*.

Here's how to do that.

- 1.** Have the board of directors approve the loan in a resolution that specifically defines it as a loan and record that action in the corporate minutes. Try to abstain from personally voting since the transaction involves a question of self-interest.
- 2.** Record the transaction as a loan on the company's books, i.e., an asset of the company.
- 3.** Sign a formal promissory note with a specific maturity date (never open-ended).
- 4.** Set up firm repayment dates (monthly, quarterly, etc.), and resist the temptation to change them.
- 5.** Pay a fair rate of interest, preferably what your company pays to its lenders, but at least the IRS prescribed interest rate, currently about 5%. This provides additional assurance that your loan is an arm's-length transaction.

6. If there are minority owners in the business and the loan from the company is substantial, obtain their approval in advance.

7. Try to give the company some collateral against the loan, particularly if this is the standard practice with other company loan agreements. Again, this is further support that the transaction was effected on an arm's-length basis.

8. Make sure your annual compensation is *comparable* to other executives in similar-size companies in your industry so the loan doesn't look like a subterfuge to supplement your lower-than-average salary.

Legal Cautions

Before borrowing from your company, check carefully your corporate charter and bylaws, your state's laws, and any bank loans or shareholder agreements you or the company previously signed. *Here's why:*

- Some corporate charters and bylaws restrict loans to owner/officers. If the loan is used to take personal advantage of what should be a corporate opportunity, you may be required to make up to the corporation any losses incurred by your action.

- The laws of some states prohibit lending corporate funds to owners, officers, and directors. Others permit it, but only under certain conditions, e.g., consent of two-thirds of the stockholders.

- Bank and other third-party loans usually prohibit or restrict an owner's ability to borrow from the company. Similar restrictions/prohibitions may be contained in shareholder and buy-sell agreements.

Tax and Business Cautions

Tax concerns: Stockholder/officer loans from the company could raise IRS questions of unreasonable compensation or excess accumulated earnings retained in the business, which excess can be taxed at 15%.

Intent to repay: Particularly in loans to the owners of family businesses, the IRS also will look at the relationship of the parties, whether the borrower was solvent at the time of the loan, the borrower's ability to pay interest and principal repayments, and whether the parties *really* intended to have the debt repaid.

Pension plans: The cautions and alerts in this Report also apply to borrowing against your and other employees' vested interests in company retirement plans.

Cost basis: The owners of S corporations, limited liability companies, and partnerships have to be especially careful since their business structure provides that all business profits are taxed to them personally and a loan to or from the company may change their tax (cost) basis. That tax (cost) basis could affect their taxable income and their ability to use personally any company losses.

Affiliated companies: The IRS is particularly interested in transactions with *affiliated* businesses owned by the company, its stockholders, or related parties (e.g., spouse, children, and siblings). Be prepared to defend all the details of the transaction.

For example, was there a good business purpose for the loan or advance or was it simply a ploy to move money from one company to another to avoid or lessen potential taxes? Was the transaction documented with a signed, interest-bearing promissory note? Is there a repayment schedule, recorded board approval, etc.? Were the pricing and terms of any sales, purchases, and advances between the company and affiliate supported with a written contract (e.g., a purchase order)? Do the terms comply with the definition of arm's-length?

Lending Money to the Company

Be careful to document the date of the loan, interest rate to be paid, and repayment terms. You may ask *why* since it's money out of your pocket, not the company's.

Here's the reason: If your company is thinly capitalized, i.e., a high debt-to-equity ratio, say \$5 of debt for each dollar of stockholder's equity, the IRS could contend that your loan to the company is really an equity investment, not a debt instrument. *Result:* Any loan repayments to you, including interest, can be labeled a dividend, making them taxable income for you and not tax deductible by the

company. (*Reference:* For the rules on thinly capitalized businesses, refer your accountant to Internal Revenue Code, Section 385.)

Internal Revenue Code References

In IRC Section 482, *Arm's-Length* is defined as: "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's-length with an uncontrolled taxpayer. A controlled transaction meets the *arm's-length* standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's-length result)."

Related parties is defined as the company, other owners, affiliated businesses, and family members which includes the spouse, children and grandchildren, parents and grandparents, siblings, and all other lineal ancestors and descendants.

Other Code Sections — For more information, refer your accountant to IRC Section 385 (Bona Fide Debt), 316 (Dividends Defined, Corporate Distributions), 318 (Constructive Ownership), and 483 (Unstated interest).

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Best advice: Before making any loans to or borrowing from the company on behalf of owners, executives, employees, board members, family members, and affiliated businesses, review the facts and cautions in this Report with your accountant and lawyer. □

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

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