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Loaning Money Company

July 2012

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Tax Tip

Introduction

In the most rudimentary statements about United States Currency, a dollar bill is a dollar bill. The dollar in your right pocket is as equal in value as the dollar in your left pocket. One hundred pennies stored in a jar has the same value as a dollar bill in your wallet or purse. A dollar bill in you bank account is the same measure of value as a dollar tucked in a drawer. Further, a dollar that you earned today carries the same face value as the dollar you earned yesterday. On the other hand, one dollar belonging to your company is not the same as a dollar belonging to you personally.

Why is this? Several potential problems can arise when lending or investing money to or from your own corporation. First, as mentioned above, money is money. Corporate money looks no different from a dollar owned personally and therein lays one problem. Second, the legal position of a company dollar and a personal dollar are different. Finally, the tax positions of the dollars are different moving from personal dollar to corporate dollar.

The purpose of this publication is to explain the potential problems that must be taken into consideration whenever anyone loans money to his/her own corporation or takes a loan from his or her own corporation. Here are three situations:

I. The Common (Day-to-Day) Scenario

The most typical situation involves an owner who loans money to his/her corporation in order to keep the corporation afloat and has no real intention of receiving the funds back until or unless the corporation has excess funds that it does not need for operating purposes. In situations of this nature, legal documents may or may not be prepared. Unfortunately the Internal Revenue Service has a policy of reclassifying the debt as equity. This reclassification results in the loss of the company to repay not only the principal of the loan but also any interest due on the loan. For accrual basis taxpayers, even the interest that is accrued must be reclassified as equity. As a matter of fact, the government states that any funds paid to the stockholder that are said to be interest payments will be reclassified as dividend distributions. In such a reclassification, the corporation will lose any tax deduction that it might have obtained if

the payment to the stockholder had been shown as an interest payment on the loan. Further, the stockholder still must pay taxes on the receipt of the dividend distribution.

The same outcome is typical when there is a lawsuit of the corporation of the individual or corporation. Without records in place, simply stated, one dollar looks the same as another dollar. Creditors are at liberty in these situations when the required records are not present.

II. A Second Situation: Debt Forgiveness

An alternative to repayment of a loan occurs when the stockholder forgives the debt and does not receive any funds back from his/her company. In addition, a situation may arise where an individual realizes, subsequent to loaning money to his/her company, that the company may never have the ability to repay the funds. Many times the stockholders forgive the corporation from repaying the debt. The tax consequences of this situation depend upon the relationship of the creditor to the company.

III. Structured as a Valid/True Loan

When an individual loans money to a privately held company AND receives proper authorization from the company's Board of Directors supported with legal documents, i.e. loan papers, corporate resolutions, and a schedule for repayment, the law generally allows the loan to remain on the books of the company as a valid third party obligation. The financial accounting records will show a debt from the corporation to the individual. Interest will be deducted by the corporation and will be taxed to the stockholder upon receipt. Finally, when the principal of the loan is repaid, whether it be in installments or a lump sum, the corporation does not obtain any tax deduction, nor does the stockholder report any income upon a return of his/her funds.

Conclusion

Obviously, readers should be cautioned when they loan money to their corporation. Any loan between a business owner and his or her company should be

purposefully structured as a valid and true loan. In other words, there should be 1) proper legal documents drafted, 2) a definite payment schedule created together with 3) a company resolution resolution. The IRS has the right to reclassify the debt if the relationship between the creditor and the company is that of a stockholder and if the loan is really an additional investment in the company with no true intention of repayment. The courts, over the years, have identified many factors to be considered in reclassification of the transaction.

Most small business owners, hampered by day-to-day operations, are currently fostering loans on a blasé or even inadvertent basis. Those who have loaned or taken a loan from their company in such a manner should be concerned and should resolve the potential problem before it becomes an actual one. Please contact The Center with any questions you may have.