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SHAREHOLDER LOANS ATTRACT IRS AUDITS

By Victor Sy, CPA, MBA

There is a new kid on the audit block: [Loans to shareholders](#). These are amounts [borrowed](#) by shareholders of corporations. They borrow funds from closely held businesses and fail to make repayments. This matter is even worse when the shareholder as employee gets [little or no salary](#). The issue that started to attract renewed IRS scrutiny is the conversion of those loans to [constructive receipts of dividends](#). Dividends, as you know, cannot be expensed by a regular corporation but have to be declared as income by the recipient shareholder.

[Constructive dividends](#) are not distributions that are planned or declared by the business but instead arise as a result of an IRS examination (audit).

It is indeed tempting for shareholders to borrow money from their own businesses as they please, as they need, without thinking of repaying them. The situation grows from bad to worse when these loans are allowed to [accumulate](#) to a point that it becomes a glaring item in the corporate tax returns. If the IRS audits the tax returns, it becomes an issue, a bad one. The loans can be [re-characterized as dividends](#) that cannot be deducted by the business but have to be taxed on the owners' individual tax returns. The loans can also be characterized as wages - resulting in payroll taxes that should have been withheld from the employee and taxes that should have been paid for employer's share. IRS auditors are now equipped with a whole section devoted to loans to and from shareholders in their audit techniques under MSSP (Market Segment Specialization Program).

How can one avoid shareholder loan problems? According to IRS regulations, a genuine debt occurs only when there is a [legally valid and enforceable obligation](#). It has to be reasonable. There should be a reasonable [expectation of repaying](#) on the part of the shareholder and a reasonable expectation of enforcing the collection on the part of the corporation. According to the Tax Court, the following factors enhance the view of a bona fide debtor-creditor relationship:

1. A promissory note or other written note of the debt is prepared and signed,
2. Interest is charged,
3. There is a fixed schedule of repayment,
4. The loan is secured by collateral,
5. If the debt becomes past due, a demand for repayment is made,
6. Your corporate books reflect the transaction as a loan,
7. Repayments are made,
8. Borrowers were solvent at the time of the loan.

The shareholder loan issue invites a closer scrutiny if the lender is a [closely held corporation](#). Because of the absolute control exercised by the shareholder, courts have modified the traditional factors mentioned above by considering additional criteria:

1. The taxpayer's degree of control over the corporation,
2. The existence of external restrictions such as bank covenants on the amounts of disbursements to shareholders, the corporation's earnings and dividend history, the ability of the shareholders to repay the loans, the shareholders' intention and attempt to repay the loan.

Tip: Make some payments, even a small amount from time to time. This indicates the existence of a true loan. Successful defenses on IRS audits have identified the key to winning on this issue: Repaying the loans in full occasionally. Use a credit line, borrow from your credit card, and raise funds from anywhere to pay-off at the end of the year. I have personally found out through audits (that I have defended) that some repayments and a subsequent valid effort to enforce repayment have saved the day for some seemingly lost cases. I also had to contend with a typical IRS approach to loans to family members as a two-step transaction: First, as a dividend distribution from this corporation to the shareholder and, second, as a loan from the shareholder to the family member. The shareholder, not the corporation, is stuck with a non-business bad debt and has to pick up dividend income. The IRS may also argue that if it is a non-business bad debt at the corporate level, there is no corporate deduction for the loss because it is not an ordinary and necessary business loss.

In conclusion, shareholder loans become an [issue on IRS audits](#) when they are converted to constructive dividends. This problem is caused by shareholders getting loans and failing to conduct these transactions at arm's length. The **lack of formality** in dealing with these loans is the usual culprits for losses at IRS audits. It is not so bad when the loans are [converted to salaries](#) because such wages are deductible by the corporation and, therefore, offset the tax effect of picking up the income on your individual income tax returns.

What should you do at this time? Clean up your books by formalizing the transaction and substantiating the loan arrangement by preparing [promissory notes](#), demand letters. Create a regular and systematic [repayment](#) schedule of outstanding loans. If you have the funds, [pay off the loan balances at the end of the year](#). If you do not have the resources, borrow, pay it off and after some reasonable period of time, reborrow and pay back your sources. Sit down with your tax adviser and plan to clean up before the IRS comes calling. Do not forget to include such borrowings in your corporate minutes. Good Luck.

Update: EDD (Employment Development Department of California) is on the lookout for S corporation shareholders who take little or no salary. California conforms to federal law that payments to shareholders who perform services for the corporation but do not receive a salary for services - are wages, not distribution of earnings and profits that could qualify for the special 15% rate on dividends.