

Using Loans to Extract Cash From a Closely Held Corporation

CASE STUDY

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Lending corporate cash to shareholders can be an effective way to give the shareholders use of the funds without the double-tax consequences of dividends. However, an advance or loan to a shareholder must be a bona fide loan to avoid a constructive dividend. Further, the loan must have an adequate interest rate to avoid deemed dividends under the below-market loan rules of Sec. 7872.

Establishing a Bona Fide Loan

Whether withdrawals from a corporation are loans or distributions depends on whether, at the time of the withdrawal, the shareholder intended to repay the amounts received and the corporation intended to require payment. It is not enough for a shareholder to declare that he or she intended a withdrawal to be a loan. There must be more reliable evidence that the transaction is debt. Some of the factors used to determine whether an advance should be treated as a loan or a dividend include:

1. The extent to which the shareholder controls the corporation. If a shareholder has unlimited control of a corporation, it is likely that loans will not be arm's-length transactions. Therefore, a greater potential for disguised constructive dividends exists. In determining control, both direct and indirect stock ownership must be considered.
2. The earnings and dividend history of the corporation. A corporation's history of not paying dividends despite the existence of sufficient earnings and profits may indicate that loans to shareholders should be considered constructive dividends, particularly where other evidence of indebtedness is lacking.
3. The magnitude of the advances and whether a ceiling existed to limit the amount. The lack of a ceiling limiting the amount a shareholder can withdraw from the corporation is indicative of a constructive dividend rather than a loan. In addition, sizable advances in relation to corporate profits or shareholder salaries may also be evidence that a distribution is not a loan.
4. How the parties recorded the advances on their books and records. The fact that distributions are recorded on the corporation's books and/or the shareholder's personal financial statements as shareholder loans is some evidence that they should be considered loans. However, the Tax Court has stated that this factor is not determinative without further evidence substantiating the existence of a bona fide loan (*Baird*, 25 T.C. 387 (1955)).
5. Whether the parties executed notes. While a formal note is evidence that a shareholder distribution is a loan, the lack of such a note or certificate of debt is not a determinative factor. The true substance of the transaction is the key factor.
6. Whether interest was paid or accrued. The failure to charge interest on shareholder loans or advances is normally an indication that a true debt arrangement does not exist. However, in closely held corporations, non-interest-bearing notes may be intended. In such cases, the below-market interest rules of Sec. 7872 come into play. Also, if interest charges are merely recorded on the books and added to the loan balance, such amounts likely would give little weight to substantiating the existence of a true debt.
7. Whether or not security was given for the loan. The existence of collateral or security is a strong indication that a shareholder loan is intended, and a lack of collateral or security indicates that the transaction was not a loan. However, the lack of security has not been a major factor in various court decisions in this area. One arrangement that might be considered is placing a provision in the corporation's bylaws stating that any shareholder loans are considered to be secured by the shareholder's stock in the corporation.
8. Whether there is a set maturity date. A fixed maturity date for a shareholder loan can be a strong indication that a true loan is intended. However, where term loans are regularly renewed without payment, with interest charges added to the note balance, little weight will be given to the maturity dates. Shareholder advances without set maturity dates can still be considered loans if other factors indicate that the arrangement is a true loan.
9. Whether the corporation ever enforced repayment. Such action on the part of a corporation would indicate that a true debt arrangement exists. However, this factor is unlikely to be present in the case of controlled corporations.

10. Whether the shareholder can repay the advances. The fact that a shareholder actually has the financial ability to repay a corporate advance is some indication that a true debt may exist. On the other hand, the fact that a shareholder may not be able to repay the advances would certainly indicate the lack of a true shareholder debt. The fact that a shareholder has a good credit rating will have little weight if the shareholder is never asked to repay the advances.
11. Whether the shareholder attempted to repay the advances. The repayment of corporate advances by a shareholder is an indication that a debt relationship exists. However, the repayment must be bona fide. Occasional repayments through bonus payments, or the application to the loan balance of other corporate payments to the shareholder while the loan balance continues to grow, probably will not be a strong indication of a bona fide loan.
12. Whether the advances were in proportion to stock ownership. Advances proportionate to stock ownership may be an indication of constructive dividends even where no one shareholder is in control of the corporation. In a closely held corporation, two or three shareholders may agree to advance themselves an amount in proportion to their stock ownership rather than pay salaries or dividends. If other indications of a bona fide debt arrangement do not exist, the IRS would probably hold that such distributions were made to avoid income and/or employment taxes.

To help ensure that amounts owed to the corporation by its shareholder(s) are bona fide loans, the corporation and shareholder(s) should sign a written note with commercially reasonable terms. The corporation should pass a resolution authorizing the advances, and the loans should be authorized in the corporate minutes. Advances should be properly recorded, and the notes should include repayment schedules and maturity dates. Also, limits should be placed on the amount of shareholder advances. The notes should bear interest at a rate that is not less than the short-term applicable federal rate (AFR) on the date of the note (or blended AFR for demand loans outstanding for the entire year). The shareholders should repay principal and interest according to the terms of the note.

Issuing Dividends to Pay Loans to Shareholders

For 2014, the tax rate on dividend income is:

- 15% for taxpayers with a marginal tax rate of 25% or greater whose taxable income falls below the levels for the 39.6% regular tax rate (\$457,600 for married filing jointly, \$406,750 for single filers, \$432,200 for heads of household, and \$228,800 for married filing separately);
- 20% for taxpayers with taxable income above those levels; and
- 0% for taxpayers with a marginal tax rate on ordinary income below 25%, to the extent the gain would be taxed at ordinary rates below 25% if it were ordinary income.

Because of the low dividend tax rates, a corporation can issue dividends to a shareholder that are used to repay a loan due the corporation by the shareholder. This is more advantageous than forgiving the loan, which results in cancellation-of-indebtedness income that is taxable as ordinary income. However, there are some risks with this strategy. The IRS may claim that the loan was really a dividend that is subject to the shareholder's higher tax rate in the year the loan was made. Furthermore, dividends should be paid proportionally based on ownership interest. When more than one shareholder exists and the loans are not proportional to ownership, this strategy may not be feasible.

Furthermore, a 3.8% net investment income tax applies to the lesser of (1) net investment income or (2) the excess of modified adjusted gross income over \$250,000 for married filing jointly, \$200,000 for single filers, and \$125,000 for married filing separately. This means that the top tax rate on qualified dividends for higher-income individuals is 18.8% (15% + 3.8%) or 23.8% (20% + 3.8%).

Borrowing From Retirement Plans

When the shareholder or employee is unable or unwilling to borrow from the corporation, a bank, or other source, funds that have accumulated within a qualified retirement plan may be a good alternative. IRS guidelines permit limited borrowing from corporate qualified retirement plans, including 401(k) plans.

As a general rule, loans between a participant and a retirement plan are prohibited transactions (Sec. 4975(c)(1)). However, there is an exemption for loans to participants that meet the following requirements (Sec. 4975(d)(1)):

1. Loans are available to all plan participants or beneficiaries on a reasonably equivalent basis and are not made available to highly compensated employees in an amount greater than the amount made available to other employees;
2. The loan is made in accordance with specific loan provisions set forth in the plan; and
3. The loan bears a reasonable rate of interest and is adequately secured.

The loan must be evidenced by a legally enforceable agreement (which may include more than one document). The agreement must specify the loan amount, term, and repayment schedule. It must be in writing, but it does not have to be signed as long as it is enforceable under applicable law (Regs. Sec. 1.72(p)-1, Q&A-3).

In general, borrowings are limited to 50% of the participant's account balance up to a maximum of \$50,000 and must be repaid within five years (unless the loan proceeds are used to purchase a principal residence, in which case repayment terms are limited by the individual plan) (Sec. 72 (p)(2)).

Hardship withdrawals (which are different from a loan, which must be repaid to the plan) from 401(k) plans may also be possible in certain circumstances. However, hardship withdrawals before age 59½ are subject to a 10% penalty tax.

If the borrower leaves the company before the loan is repaid, the balance will be treated as a distribution and will be subject to income tax (and the 10% penalty if the borrower is less than age 59½). An obvious solution, if the borrower has the financial wherewithal before leaving the company, is to repay the loan.

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