**Abstract:**  Owners occasionally borrow funds from their businesses. This article explains the importance of treating these transactions as bona fide loans and charging an “adequate” rate of interest. It also provides a list of factors the IRS considers when evaluating corporate advances to shareholders.

**How to steer clear of tax issues related to shareholder loans**

Owners occasionally need to borrow funds from their businesses. If your business is structured as a corporation and it has extra cash on hand, a shareholder loan can be a convenient and low-cost option — but it’s important to treat the transaction as a bona fide loan. If you don’t, the IRS may claim you received a taxable dividend or compensation payment rather than a loan.

**Taking a closer look**

A corporation can make de minimis loans of $10,000 or less to shareholders without paying interest. But, if all of the loans from the corporation to a shareholder add up to more than $10,000, the advances may be subject to a complicated set of below-market interest rules *unless* you charge what the IRS considers an “adequate” rate of interest. Each month the IRS publishes its applicable federal rates (AFRs), which vary depending on the term of the loan.

Right now, although interest rates are starting to rise, they’re still near historic lows, making it a good time to borrow money. For example, in July 2017, the adjusted AFR for short-term loans (of not more than three years) was only 1.22% (up from 0.71% in July 2016). The rate was 1.89% (up from 1.43% in July 2016) for midterm loans (with terms ranging from more than three years to not more than nine years).

The AFRs are typically below what a bank would charge. As long as the corporation charged interest at the AFR (or higher), the loan would be exempt from the complicated below-market interest rules the IRS imposes.

The interest rate for a demand loan — which is payable whenever the corporation wants to collect it — isn’t fixed when the loan is set up. Instead it varies depending on market conditions. So, calculating the correct AFR for a demand loan is more complicated than it is for a term loan. In general, it’s easier to administer a shareholder loan with a prescribed term than a demand note.

**Staying under market**

If a corporation lends money to a shareholder at an interest rate that’s below the AFR, the IRS requires it to impute interest using the below-market interest rules. These calculations can be complicated. The amount of incremental imputed interest (beyond what the corporation already charges the shareholder) depends on when the loan was set up and whether it’s a demand or term loan. There are also tax consequences for this imputed interest to both the corporation and the shareholder.

Additionally, the IRS may argue that the loan should be reclassified as either a dividend or additional compensation. The corporation may deduct the latter, but it will also be subject to payroll taxes. Both dividends and additional compensation would be taxable income to the shareholder personally, however.

**Making it bona fide**

When deciding whether payments made to shareholders qualify as bona fide loans, the IRS considers a variety of factors. It assesses the size of the loan, as well as the corporation’s history of earnings, dividend payments and loan repayments. It also looks at the shareholder’s ability to repay the loan and power to make corporate decisions.

In addition, the IRS will factor in whether you’ve executed a formal, written note that specifies repayment terms — including the interest rate, maturity date and collateral.

**Getting started**

Under the right circumstances, a shareholder loan could be a smart tax planning move to make this year. Contact our firm to help you set up and monitor your shareholder loans to ensure compliance with the IRS rules.

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