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NEW IRS AUDIT TECHNIQUE GUIDE PINPOINTS PROBLEMS TO AVOID WHEN MAKING SHAREHOLDER LOANS

IRS recently released a comprehensive Market Segment Specialization Program (MSSP) Audit Technique Guide on Shareholder Loans. This Audit Guide provides valuable information for setting up, monitoring or reporting the tax consequences of shareholder loans from corporations. It pinpoints the problem areas IRS agents are instructed to probe, and explains how imputed interest should be calculated in a variety of term- and demand-loan situations, complete with Excel™ spreadsheet formulas.

Following is an overview of some of the key areas agents are instructed to examine when determining whether an advance is a bona fide shareholder loan.

WHETHER AMOUNT IS A BONA FIDE LOAN

The test for deciding if a disbursement to a shareholder is a loan is whether, at the time it was made, the shareholder intended to repay it and the corporation intended to require repayment. However, it's not enough for the shareholder and an officer of the corporation to testify they each had the requisite intent. This intent must be shown by objective facts.

Following are the twelve factors most often considered in deciding whether withdrawals are loans or distributions and the MSSP Guide's interpretation:

1. *The extent to which the shareholder controls the corporation.*

The probability of an arm's length transaction is far greater if the shareholder receiving the loan does not own a majority (directly or through attribution) of the corporate stock. However, the MSSP Guide stresses the critical element is the extent to which the shareholder can control the corporation's affairs, regardless of whether control derives from stock ownership, family relationship or some other source.

2. *Whether security was given.*

The failure to provide security may be an indication a distribution was intended. However, the MSSP Guide notes that, in *Shea, Richard v. U.S.*, (1982, DC AL) 51 AFTR 2d 83-658, the court held that where a corporation's articles of incorporation provide that it has a lien on its shares of stock for any debt or liability incurred to it by a stockholder, the fact that no security is given for the advances made to a shareholder does not preclude a finding that the advances are bona fide loans, even though the shareholders were unaware of this provision when the advances were made.

3. *Is the shareholder in a position to repay the loan?*

The shareholder's salary, other income and net worth are relevant in determining the shareholder's ability to repay, but the MSSP Guide notes, in Smith, Robert, (1980) TC Memo 1980-15, the mere fact a shareholder had a good credit rating was not conclusive to establish he could repay the advances.

4. *Adequate earnings and profits.*

The fact that a corporation has a deficit or no earnings and profit (E&P), doesn't mean a distribution is a bona fide loan. It simply means the distribution cannot be classified as a dividend, but could be a return of capital or capital gain. Agents are told to consider whether there is adequate E&P before challenging the validity of a loan.

5. *Certificate of debt is given to the corporation.*

Agents are told the lack of a note is not a determinative factor. The MSSP Guide points out there are numerous court cases where no note was issued for advances, but, based on other factors, the advances were accepted as bona fide loans.

6. *Is there a repayment schedule or an attempt to repay?*

Agents are cautioned that even if repayments are made, the fact that the amount advanced continues to increase over a sustained period of years would tend to support constructive dividend treatment.

7. *Is there a set maturity date?*

The MSSP Guide says that even in the absence of a fixed maturity date, a loan will be respected as such if it is repaid within a reasonable period of time. However, constructive dividend treatment may be indicated where an examination reveals a shareholder annually reissues a term note for the previous amount owed, plus some or all of the accrued interest.

8. *Whether the corporation charges interest.*

Generally, a failure to charge interest supports a finding that there's a constructive dividend or that there are imputed dividends under the below market interest rules.

9. *Whether the corporation has made systematic efforts to obtain repayment.*

A shareholder's failure to make payments, or only minimal payments, indicates a constructive dividend, particularly if the corporation is not taking steps to enforce the loan. If a closely held corporation does not apply pressure on a borrowing shareholder for repayment, the transaction may not be at arm's length.

10. *Magnitude of the advances.*

The MSSP Guide tells agents that large advances to a controlling shareholder, where his ability to repay is essentially contingent on future events, is an indication of a constructive dividend.

11. *Whether there's a ceiling on the amount the corporation can advance.*

Although seldom a key factor, the existence of a numerical ceiling on the amount that can be advanced to a shareholder would tend to support a finding that the advance is bona fide debt. The MSSP Guide notes that courts have also held that a corporation's having to obtain the consent of an equal controlling block of stock to make an advance imposes a de facto ceiling on the amounts that can be advanced.

12. *Dividend history of the corporation.*

Adequate earnings and profits with respect to the advances made, coupled with no history of paying dividends, favors constructive dividend treatment.

The MSSP Guide stresses the above 12 factors must be viewed as a whole and list is not all-inclusive. Agents are told to delve into any facts which may provide insight into the parties' intent at the time of the distribution.

S CORPORATION ISSUES

If the entity making the advances is an S corporation and the initial determination is that a debt is bona fide using the above factors, examining agents are told that another test of the validity of the debt must be considered; namely, whether the S corporation reasonably compensated the shareholder who received the advances. If it did not, agents are told to evaluate whether all or part of the advances should be reclassified as compensation, subject to employment taxes.

Observation:

A C corporation usually will try to pay out the maximum amount of deductible compensation to shareholder-employees (within "reasonable compensation" limits) to avoid double taxation. In an S corporation, there is no need to pay additional compensation because there is no double tax. Payroll taxes may encourage shareholder-employees to set compensation at the low end since amounts not paid out as compensation will be taxed to them as passed-through income in any event.

Once the examining agent has determined advances made by an S corporation to a shareholder are not bona fide debt, he is directed to see if the S corporation's Accumulated Adjustments Account (AAA) has a sufficient balance to absorb the advance. If the answer is "yes," there is no tax impact and the AAA is reduced by the amount of the advance. If the AAA is less than the advance in question, and no prior accumulated earnings and profits exist from a prior C corporation status, the examining agent must consider whether the shareholder who got the advance received reasonable compensation. The examining agent also is told to probe whether the advance/distribution was made with respect to the shareholder's stock.

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