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Beyond the Numbers...

Essential guidelines for owner-involved business loans

Loaning money to your business or borrowing from it isn't just a way to fill a financial gap; it can be a strategic move in certain situations. However, there are vital considerations to bear in mind to ensure these transactions are above board and safeguarded against legal or tax issues.

The legality of it all

While loans to or from your business can offer many advantages, the IRS keeps a watchful eye on these kinds of transactions. There are cases where the IRS has re-characterized loans from the business as wages, dividends, or distributions. This makes it crucial to ensure that these transactions are entirely above board.

To safeguard against potential IRS issues, business owners should consider the following guidelines when executing a loan to or from their business:

Keep it formal

It can be easy to overlook certain formalities, especially if you're the sole stakeholder in your business. However, proper documentation is critical to avoid potential legal issues. You should always have a legally binding promissory note for business loans of any nature. This document should clearly outline the terms, interest rate, and repayment schedule.

Likewise, accurate bookkeeping goes hand-in-hand with formal documentation. Ensuring that loans are recorded in your business's financial statements and ledgers adds another layer of protection. It helps provide a clear trail of the transaction for both internal review and external audits, reducing the likelihood of disputes.

Set reasonable interest rates

If you're taking a loan from your business, it's wise to align the interest rate with the applicable federal rate. The applicable federal rate is established by the IRS and serves as a benchmark for reasonable interest rates on loans. If you set an interest rate lower than the applicable federal rate, this could raise red flags with the IRS and indicate that the loan is actually disguised compensation.

It's also a good practice to justify your chosen interest rate, regardless of whether you are taking a loan from your business or lending to it. This could involve documenting the applicable federal rate or comparable bank rates at the time the loan is made. The more you can substantiate the rate, the more you'll be able to demonstrate the loan's legitimacy in case of an audit or inquiry.

Keep other stakeholders informed

Before entering into any loan transaction with your business, it's essential to review your company's operating agreement, as it likely contains provisions regarding loan transactions, approval processes, and other governance protocols. Ignoring these guidelines could potentially create legal complications down the line.

Once you've consulted the operating agreement, the next step is to secure input and approval from other stakeholders. This is not only a matter of good governance but critical for maintaining trust and transparency within your organization. If a vote is held on whether to approve the loan, it's a good idea to recuse yourself to avoid conflicts of interest.

Equally important is the documentation of discussions related to the loan. Always maintain thorough meeting minutes that capture the essence of the conversation, the decision-making process, and the ultimate resolution about the loan. Even if your operating agreement doesn't require a formal board resolution, it's generally prudent to err on the side of caution and obtain a board resolution approving the transaction. This adds an extra layer of legitimacy and can protect against future misunderstandings.

Be realistic about repayment terms

You need to be realistic when setting repayment terms for a loan transaction. Consider the business's existing debt obligations and carefully assess its cash flow projections. Your repayment schedule should be achievable and include some financial wiggle room to account for unexpected expenses or revenue shortfalls.

If you're lending money to the business, you need to understand the priority of the loan. Loans from external lenders or outstanding tax obligations usually take precedence over personal loans in the repayment hierarchy. You should check any existing loans for subordination clauses because this means they will need to be repaid first in the event of liquidation or bankruptcy.

In the unfortunate event of bankruptcy, owner loans are generally among the last in line for repayment, following other creditors like secured loans, employee wages, and tax obligations. One way to mitigate this risk is by attaching appropriate collateral to the loan agreement because it could give you priority over unsecured creditors. However, you should consider this option carefully because it can have downstream effects on the business's ability to secure additional external financing. Future lenders may be less willing to offer loans if they see that the business already has multiple existing obligations, including a secured personal loan from an owner, that could interfere with repayment.

Avoid red flags

Be mindful of actions that might raise red flags with tax authorities and compromise your legal standing. For instance, small and consistent loan amounts, or loans that are quickly repaid at year-end and immediately renewed, can indicate a sham debtor-creditor relationship. Not only can these activities invite increased scrutiny from the IRS, it could also be viewed as commingling personal and business assets. Such behavior could jeopardize the limited liability protections provided by your corporate structure.

For owner-employees, it's important to ensure that you're receiving a reasonable salary from the business. This helps avoid a claim by the IRS that business loans to an owner are disguised compensation. Failing to take a reasonable salary while taking out loans from your business could lead to the loans being reclassified as wages, which would be subject to back taxes, penalties, and interest.

Owners operating within a C-corporation structure should be particularly cautious. The allure of sidestepping taxes by extracting profits as loans instead of dividends can be tempting, but it's a high-risk strategy. If the loan isn't carefully structured and treated as a genuine arm's-length transaction, the IRS could reclassify it as dividends or wages.

Final Thoughts

Before engaging in any loan transactions with your business, consult with financial and legal experts to ensure you comply with all relevant laws and regulations. If you would like to discuss lending to or from your business with one our expert advisors, please contact our office.
We're always happy to help.

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