

June 29, 2010

Dear Client,

In recent months, we have noticed an area of increased scrutiny in tax audits. The Internal Revenue Service is closely examining the withdrawals of funds from controlled corporations in the form of shareholder loans. While dividends are now taxed to noncorporate shareholders at capital gains rates, a loan from a corporation to its shareholder is not subject to tax. Even though distributions may be recorded as loans, the IRS can treat shareholder withdrawals of cash from a corporation as dividends, if they aren't structured properly.

A Tax Court case demonstrates what can happen when a shareholder isn't careful, and treats a controlled corporation as though it were a personal bank account. In that case, a husband and wife wholly owned the corporation. The husband, John, ran the corporation, and dealt with it very informally. He took money out as needed for personal expenses, and received a \$100 check along with each weekly paycheck. John and the corporation accounted for these withdrawals as "shareholder advances," and both John and the corporation showed these advances as loans on financial statements that were given to third parties. At the end of every year, part of the outstanding balance of the shareholder advances account was repaid by crediting John's year-end bonuses against it. On audit, the IRS determined that the shareholder advances weren't true loans, and treated them as dividends. The Tax Court agreed that the withdrawals were dividends and that the year-end repayments didn't establish existence of true loans because there were no written agreements obligating John to repay the advances, the loans had no maturity date, no ceiling, and no security, and the corporation had earnings and profits, but never made dividend distributions. As you can imagine, this could have a significant impact on your tax situation and cash flow.

In characterizing whether a withdrawal is a loan or a dividend, there are 12 factors that the courts consider in making this determination. Most of these are within your control. One important factor, for example, is whether there is a written promissory note. It isn't necessary that each of the factors indicate a loan exists, but taken together they must be sufficient to establish that the withdrawal is not a dividend.

- (1) Whether a ceiling existed on the amounts that could be advanced to the shareholder. There would be a practical limit on the amount that could be advanced before approval by another shareholder is required.
- (2) Whether security is given for the advances. There would be such security if the corporation's articles of incorporation provide that the corporation will have a lien on the shareholder's shares of stock for any debt of the shareholder to the corporation even if the shareholders are unaware of the provisions in the articles when the advance is made.

- (3) Whether the shareholder was in a position to repay the advance. The shareholder's salary as an employee of the corporation is taken into account in making that determination.
- (4) Whether there is a repayment schedule or an attempt to repay.
- (5) Whether there is a set maturity date. If there is none, actual repayments may be taken into account to determine when the loan is likely to be repaid.
- (6) Whether interest is charged. If interest is not charged, consideration will be given as to whether interest-free loans are made to non-shareholder employees.
- (7) Whether the corporation made systematic efforts to obtain repayment. This factor is not key, however, where the employee follows a voluntary repayment schedule that is reasonable.
- (8) The size of the advances.
- (9) The extent to which the shareholder controls the corporation.
- (10) The earnings and dividend history of the corporation.
- (11) Whether a note or certificate of evidence was taken by the corporation.
- (12) How the shareholder and the corporation recorded the advances on their books and records.

As you can see, these are all items that should be considered before the IRS comes calling. If you find yourself wondering if you might be in this category, we would be happy to discuss your situation with you to see how we can help alleviate the risk that your withdrawals will be subject to tax as dividends. Please feel free to call the office to schedule an appointment.

You can also visit our website at www.gccpas.net for additional information that may pertain to your business or if you would like to sign up to receive our e-newsletter.

Sincerely,

A handwritten signature in black ink that reads "Grumbleby Coleman". The signature is written in a cursive, flowing style.

Grimbleby Coleman
Certified Public Accountants, Inc.