Classifying shareholder “loans” in a Business Valuation

Are loans to and from shareholders bona fide debt obligations, a form of equity capital or a hybrid of the two? The distinction is relevant when valuing a business, as well as in divorce cases. Often, experts turn to the IRS rules for objective guidance on this matter.

IRS stance

Owners occasionally borrow funds from their businesses, say, to pay a child’s college costs or provide a down payment on a vacation home. These loans to shareholders appear on a company’s balance sheet as a receivable.

For loans of more than $10,000, the IRS requires taxpayers to treat the transaction as a bona fide debt. Then the company must charge the shareholder an “adequate” rate of interest. Each month the IRS publishes its applicable federal rates (AFRs), which vary depending on the term of the loan.

If the company doesn’t charge interest or follow a complicated set of below-market interest rules to impute interest on the loan, the IRS may claim the shareholder received a taxable dividend or compensation payment rather than a loan. The company may deduct the latter, but it will also be subject to payroll taxes. However, both dividends and additional compensation would be taxable income to the shareholder personally.

Loans may also be made from the shareholder to the business. These transactions appear as a liability on the company’s balance sheet. Interest should also be charged or imputed on these amounts. Interest expense is claimed as income by the shareholder and deducted as an expense by the business.

Valuation connection

Classifying debt vs. equity transactions may also be relevant when estimating the value of an equity interest in a business. In some cases, a business valuation professional may decide it’s appropriate to reclassify a note to or from a shareholder to the equity section of the balance sheet, because management has treated the transaction as a capital contribution, a distribution or a draw on the shareholder’s equity account.

In turn, such reclassification may reduce the amount of debt in the company’s capital structure, thereby possibly increasing its cost of capital. (That’s because the cost of debt is typically less than the cost of equity.) The cost of capital is a key input when applying the income approach.

Likewise, when using invested capital methods — which derive preliminary values that include both interest-bearing debt and equity — experts must subtract interest-bearing debt to arrive at the value of
equity. So, to the extent that shareholder loans have been reclassified from debt to equity, the expert will have less debt to subtract from the value of invested capital.

In divorce cases, the distinction may be particularly important, depending on when an asset was acquired or a debt was incurred. For example, a marital estate might specifically exclude a business interest that was acquired before the couple was married, but it might include a loan made during the marriage to keep the company afloat during a market trough. Or the marital estate might include loans from the company to pay for a shareholder’s personal expenses incurred during the marriage. Matters are more complicated for businesses with multiple owners.

6 factors

When deciding whether payments made to shareholders qualify as bona fide loans, the IRS considers these six factors:

1. Loan size,
2. Earnings and dividend-paying history,
3. Provisions in the shareholders’ agreement about limits on amounts that can be advanced to owners,
4. Loan repayment history,
5. The shareholder’s ability to repay the loan, based on his or her annual compensation, and
6. The shareholder’s level of control over the company’s decision making.

The IRS also asks whether the shareholder executed a formal, written note that specifies the repayment terms, such as the interest rate, a maturity date, any collateral pledged and a repayment schedule.

Debt or equity?

The classification as equity or debt can potentially have a material impact on the overall value of the firm. Deciding whether transactions between a company and its shareholders qualify as debt or equity can be somewhat subjective. But the IRS guidance outlines some objective considerations that can be used to support an expert’s decision.