



The tax traps of personally guaranteeing a loan to your corporation

If you're considering guaranteeing, or are asked to guarantee, a loan to your closely held corporation, it's important to understand the potential tax consequences. Acting as a guarantor, endorser or indemnitor means that if the corporation defaults, you could be responsible for repaying the loan. Without planning ahead, you may face unexpected tax implications.

A business bad debt

If you're compelled to make good on the obligation, the payment of principal or interest in discharge of the obligation generally results in a bad debt deduction. This may be either a business or a nonbusiness bad debt deduction. If it's a business bad debt, it's deductible against ordinary income. A business bad debt can be either totally or partly worthless. If it's a nonbusiness bad debt, it's deductible as a short-term capital loss, which is subject to certain limitations. A nonbusiness bad debt is deductible only if it's totally worthless.

To be treated as a business bad debt, the guarantee must be closely related to your trade or business. If the reason for guaranteeing the corporation loan is to protect your job, the guarantee is considered closely related to your trade or business as an employee. But employment must be the dominant motive. If your annual salary exceeds your investment in the corporation, this generally shows that the *dominant*

motive for the guarantee is to protect your job. On the other hand, if your investment in the corporation substantially exceeds your annual salary, that's evidence that the guarantee is primarily to protect your investment rather than your job.

Proving the relationship

Except in the case of job guarantees, it may be difficult to show the guarantee is closely related to your trade or business. You have to show that the guarantee is related to your business as a promoter, or that the guarantee is related to some other trade or business separately carried on by you.

If the reason for guaranteeing your corporation's loan isn't closely related to your trade or business and you're required to pay off the loan, you can take a nonbusiness bad debt deduction if you show that your reason for the guarantee was to protect your investment, or you entered the guarantee transaction with a profit motive.

Note: The IRS and courts will scrutinize the dominant motive carefully. Reasonable compensation doesn't always mean money. It can include protecting employment or business interests.

Additional requirements

In addition to satisfying the above requirements, a business or nonbusiness bad debt is deductible only if you meet these three conditions:

1. You have a legal duty to make the guaranty payment (although there's no requirement that a legal action be brought against you).
2. The guaranty agreement is entered into before the debt becomes worthless.
3. You receive reasonable consideration (not necessarily cash or property) for entering into the guaranty agreement.

Any payment you make on a loan you guaranteed is deductible as a bad debt in the year you make it, unless the agreement (or local law) provides for a right of subrogation against the corporation. If you have this right, or some other right to demand payment from the corporation, you can't take a bad debt deduction until the rights become partly or totally worthless.

These are only some of the possible tax consequences of guaranteeing a loan to your closely held corporation. Consult with us to learn all the implications and to help ensure the best tax results.

