



Debt vs. equity: Classification counts when shareholders put money into their corporations

If you operate your business as a C corporation, how you put money into your company — and how you take it back out — can have a major impact on your tax bill. Payments from shareholders to fund the business can either be classified as capital contributions (equity) or shareholder loans (debt). That might sound like an accounting technicality, but it has real tax consequences because our federal income tax system treats corporate debt more favorably than corporate equity. Put simply, equity can lead to double taxation; loans can help you avoid it.

Why it matters

Companies occasionally need capital infusions. Start-ups need cash to help get the business up and running. And established businesses may need additional funds to pursue growth opportunities or cover short-term cash flow gaps. If your business needs money, you could seek financing from a third-party lender. But for closely held businesses, shareholders are often a more convenient (and affordable) source of financing.

Some closely held C corporations are funded exclusively with equity, but many are intentionally structured with a mix of equity and shareholder loans. Lending money to your corporation can be a tax-smart move over the long run.

That's because when you later get your money back out of the corporation in the form of loan repayments, the repayments of loan principal will generally be tax-free. Interest payments on a shareholder loan are taxable to you as ordinary income, but the corporation gets an offsetting deduction. In essence, shareholder loans provide a built-in, tax-advantaged mechanism for C corporation owners to get cash out of the business.

In contrast, making a capital contribution (a stock investment) can be costly from a tax perspective. When you later, as an equity investor, want to take cash out of the corporation, the withdrawals may be treated as nondeductible dividends to the extent of the corporation's earnings and profits. This results in double taxation.

In other words, the corporation already paid income taxes on the profits (at a flat 21% rate), and you as a shareholder must pay individual-level taxes on the dividends. The maximum federal rate on qualified dividends is 20%, but most taxpayers pay 15%. Individuals may also owe the 3.8% net investment income tax (NIIT) on dividends.

How it works

Suppose your C corporation needs a \$5 million capital infusion. As the sole shareholder, you ante up with a \$2 million capital contribution and a \$3 million loan. You execute a formal, written note that specifies the loan terms, including the interest rate, maturity date, any collateral pledged to secure the loan and a repayment schedule.

If the interest rate on your loan to the company equals or exceeds the applicable federal rate (AFR), you'll avoid federal income tax complications and possible adverse tax results. AFRs can change monthly. In April 2026, the monthly AFR for mid-term loans with terms of three to nine years is only 3.75%. This is significantly lower than the rate you'd get from a third-party lender.

This capital structure allows you to recover \$3 million of your investment in the company as tax-free repayments of loan principal. The interest payments give you additional cash from the corporation without double taxation, because your company can deduct the interest.

If you instead supply the full \$5 million as a capital contribution and later want to withdraw money, all or part of the withdrawal could be treated as a double-taxed dividend.

For instance, say you withdraw \$3 million after a few years, and the entire amount is treated as a taxable dividend. Assuming you'd be subject to the maximum 20% federal income tax rate and the 3.8% NIIT, you'd owe Uncle Sam \$714,000 on the withdrawal (\$3 million × 23.8%). You could have avoided incurring that tax liability by making a \$2 million capital contribution and a \$3 million loan to the corporation.

Bottom line

Structuring part of a needed capital infusion as a loan — rather than all equity — can minimize double taxation, giving you a more tax-efficient way to access cash in the future. But this arrangement only works if it's properly documented and respected as bona fide debt. This includes 1) drafting a written promissory note with a stated interest rate and stated repayment dates, and 2) making timely principal and interest payments. The IRS may reclassify shareholder loans as equity if they're not properly structured, thereby eliminating the intended tax benefits. If you'd like to take advantage of this strategy, we can explain your options and help you structure the loan to reduce the chance of IRS reclassification.