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Advance Account Shows That Incorporation Is Not for Everyone

If you're not good at paperwork, the corporate form of business is probably not for you.

William H. Bruecher III learned that lesson by paying more than \$27,000 in taxes on monies his corporation supposedly loaned to him.

Mr. Bruecher's corporation did not pay him a salary; rather, the corporation paid his personal expenses, classifying the payments as advances.

Advance Account on Corporate Books

Advances handled properly do not create a tax problem.

The IRS in an audit, or the court in a decision, first looks to see whether the advances are loans or dividends. If repayment by the owner and collection by the corporation seem assured, or actually take place in a later year, the advance is a loan.

Intent to Repay

To decide whether there is intent to repay, the court looks at factors such as the following:

- Promissory notes or other written promises to repay the advance
- Interest charges on the advance
- Collateral to ensure repayment
- Past history of repayment

Neither Mr. Bruecher nor his corporation could produce any of these. Further, the very personal nature of some of the advances (such as divorce settlement payments, child support payments, and payments to the grocery store) got the court's attention.

In court, Mr. Bruecher delivered his self-serving testimony and presented as evidence the corporate tax return, on which the advances were classified as loans.

Not good enough, ruled the court, as it made the advances taxable dividends to Mr. Bruecher.¹

Takeaways

When you operate as a corporation, the corporation is a separate legal entity, and you should have a corporate paper trail that clearly reflects intent and action.

- **C corporation.** Clear out the advance account and make the advances interest-bearing loans, with specific repayment dates.
- **S corporation.** Either offset the advances with the distribution account or evidence the advances as interest-bearing loans.

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¹ William H. Bruecher III v Commr., TC Summary Opinion 2005-52.