How to withdraw cash from a closely held corporation

The simplest way to withdraw cash from the corporation is to distribute cash as a dividend. However, a dividend distribution is not very tax efficient, since it is taxable to you as the recipient to the extent of your corporation's "earnings and profits," but not deductible by the corporation.

There are, however, several alternative methods available to you that allow you to withdraw cash from a corporation while avoiding dividend treatment:

(1) To the extent that you have capitalized the corporation with debt, including any amounts that you have advanced to the corporation, the corporation may repay the debt without the repayment being treated as a dividend. Additionally, interest paid on the debt is deductible by the corporation. This assumes that the debt has been properly documented with certain terms that characterize debt, rather than equity, and that the corporation does not have an unduly high debt to equity ratio. Otherwise, the repayment of the "debt" will also be taxed as a dividend. If, you choose to make additional cash contributions to the corporation in the future, you may wish to consider structuring such contributions as debt in order to facilitate later withdrawals on a tax-advantaged basis.

(2) Reasonable compensation that you, or members of your family, receive for services actually rendered to the corporation is taxable to you or your family member, but deductible to the corporation. The same rule applies to any compensation (*i.e.,* rent) that you receive from the corporation for the use of property. In either case the amount of compensation must be reasonable in relation to the services rendered or the value of the property provided. To the extent the compensation is excessive, the excess will be nondeductible.

(3) You may withdraw cash from the corporation without being taxed by borrowing money from the corporation. However, in order to avoid recharacterization of the loan as a dividend, it is important that the loan be properly documented and be made on terms (including provision for interest) which are comparable to those on which an unrelated third-party would lend money to you. All payments of interest and principal on the loan should actually be made in a timely fashion.

(4) You may withdraw cash by receiving certain fringe benefits that are deductible to the corporation and not taxable to you. These may include life insurance, certain medical benefits, disability insurance, dependent care and other benefits. Most of these benefits are tax-free only if provided on a nondiscriminatory basis to other employees of the corporation. You can also establish a salary reduction plan that would allow you (as well as other employees) to take a portion of your compensation as nontaxable benefits, rather than as taxable compensation.

(5) You may withdraw cash from the corporation by selling property to the corporation. However, certain types of sales should be avoided. For instance, you should not sell property to a 50% owned corporation at a loss, since the loss on the sale will be

disallowed. Similarly, you should not sell depreciable property to a 50% owned corporation at a gain, since the gain on the sale will be treated as ordinary income, rather than capital gain. It is therefore preferable to sell either property on which you will not incur a loss or nondepreciable property to the corporation. In any event, any sale should be on terms which are comparable to those on which an unrelated third party would purchase the property. In this connection, it could be advantageous to obtain an independent appraisal to establish the value of property which you wish to sell.

If you would like any additional information regarding withdrawing cash from your corporation, please do not hesitate to contact us.