Self-Funding 101

Borrowing from your practice works, but only if done properly.

BY JAMES D. KRICKETT

A surprising number of podiatric professionals depend on themselves for financing their practice, investing, or putting money into the podiatry practice, or withdrawing or taking money from the practice, but it is not something to be tackled by amateurs. After all, thanks to our complex tax rules, putting money in or taking money out of a practice can be expensive.

Whether because conventional financing remains difficult to obtain, or it is a quicker solution, a surprising number of principals in podiatry practices depend on themselves for their financing needs. It is little wonder that self-financing is the number one form of financing used by professionals and small business owners. It's quick, doesn't require a lot of paperwork, and is often less expensive than conventional financing.

That is not to say that self-financing is without a cost. The cost that every podiatric professional using his or her own funds must consider is the so-called "lost opportunity" cost. The "lost opportunity" cost is the amount that could have, or might have, been earned had those funds remained in savings or invested elsewhere.

Funding Pitfalls

In today's current topsy-turvy economic climate, doing it yourself or financing within the family frequently produces the fastest and best results. Unfortunately, our tax laws create a number of obstacles which must be overcome to avoid penalties and corresponding higher tax bills.

Quite simply, money invested in the practice can be withdrawn... with a tax bill on any profits from the sale of that capital investment. A loan made by a podiatric professional to his or her practice can, on the other hand, be repaid tax-free if the ever-vigilant Internal Revenue Service accepts it as a bona fide, arm's length transaction.

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On a similar note, it is also expensive for any podiatrist taking money from their practice. There is an all-too-real risk that the IRS might view movement of funds from the practice to the principal/shareholder as a taxable event. As one Texas neurosurgeon recently discovered, a loan by a practice, disguised or not, can be labeled by the ever vigilant IRS as compensation, a bonus, or as a dividend—all taxable to the recipient.

A Loan by Any Other Name Is a Taxable Transaction

A recent decision rendered by the U.S. Tax Court (Frederick D. Todd II, et ux. (T.C. Memo. 2011-123)) illustrates the often-quirky tax rules governing moving money in or out of the practice... regardless of how convoluted the transaction. In this case, the doctor did business through a corporation of which he was the sole shareholder.

The incorporated practice signed up with a union through which it agreed to provide the practice's eligible employees with a death benefit plan organized through a welfare benefit fund. The doctor had his life insured for $6 million, while the incorporated practice made the premium payments.

Under the trust agreement, the employer and employee trustees had discretionary authority to make loans to anyone participating in the plan on a non-discriminatory basis. Upon application and written evidence of an emergency or serious financial hardship from the eligible employee, the trustees could make a loan up to the amount of the present value of the death benefit.

The doctor subsequently took out a loan for $400,000 for "unexpected housing costs." While the loan

Continued on page 94

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Self-Funding *(from page 93)*

was evidenced by a note, the doctor made no repayment. The loan was eventually declared in default, and the IRS jumped in claiming there was no loan, only a distribution from the plan. What's more, the IRS claimed the doctor was taxable on the $400,000.

The U.S. Tax Court could find no evidence of a bona fide loan and declared the full $400,000 was taxable income for the doctor. The Court also found the doctor liable for the 20 percent accuracy-related penalty for failure to report the receipt of the funds and underpaying his taxes.

Reversing the Bottomless Pit

A podiatrist using his or her own money will usually discover that there is more available than one might think. Although many podiatrists ordinarily think only of cash savings, there are other assets that can be liquidated and turned into that badly-needed cash. Unfortunately, there are also many drawbacks including the risk of running afoul of our tax laws and the Internal Revenue Service.

When Dr. John Jones' podiatry practice ran low on funds, things began to look grim. Repeatedly turned down by conventional lenders, even non-conventional funding sources rejected Dr. Jones's overtures. Dr. Jones' answer was to personally, guarantee a $100,000 loan, run up expenses on his personal credit card and defer his salary. In short, Dr. Jones put himself in a position where he had a lot to lose, and the only way out was to succeed and profit.

Putting yourself at risk can attract lenders or investors. Just as often, it succeeds in raising the funds needed by the practice or business. Consider a few strategies that can either put the practice at risk or provide the needed funding, or both:

- Liquidate savings. If you have it, consider giving it up.
- Take out a home-equity loan. Remember, however, there is a limit to the amount of qualified residence interest that is tax deductible. The aggregate amount of acquisition indebtedness may not exceed $1 million and the aggregate amount of home equity indebtedness may not exceed $100,000; interest attributable to debt over these limits is nondeductible personal interest.
- Get a bank loan. Usually any bank loan, if available, will require a personal guarantee—or the guarantee of friends or family members.
- Sell a vacation home.
- Take out a margin loan against your stock holdings.

But never use personal credit card debt for business purposes; it is far too costly.

Imputed Interest

When either lending to or borrowing from the podiatry practice, remember that it must be a legitimate, interest-bearing loan. Under our tax rules, a podiatrist borrowing from his or her practice can face a hefty tax bill should the IRS view the transaction as a dividend payout rather than a loan.

Often, it is below-market interest rates or the lack of evidence of an arm's length transaction that draws the attention of the IRS. The IRS is particularly interested in 1) gift loans, 2) corporation-shareholder loans, 3) compensation loans, between employer and employee or between independent contractor and client, and 4) any below-market interest loan in which the interest arrangement has significant effect on either the lender's or borrower's tax liability.

If the IRS re-characterizes or re-labels a transaction, the result is an interest expense deduction when none was previously claimed by the borrower, and unexpected taxable interest income on the lender's tax bill. The lender's higher tax bills, often dating back several years, are usually accompanied by penalties and interest on the underpaid amounts.

Always a Borrower Be

For many podiatry practices, borrowing means a loan from the principal, owner, or shareholder. In some cases, the principal borrows the funds from the podiatry practice. Not so surprisingly, loans and advances between so-called "related parties" are quite common in closely-held podiatry practices. Corporate loans to shareholders are probably the most commonly seen by IRS auditors, with advances from shareholders to the incorporated podiatry practice running a close second, particularly in the early years of closely-held but thinly capitalized corporations.

The IRS's interest in these transactions stems from the tremendous potential for tax avoidance—inadvertent or intentional. When an incorporated podiatry practice or business makes an interest-free (or low interest) loan to its shareholder, in the eyes of the IRS, the shareholder is deemed to have received a non-deductible dividend equal to the amount of the foregone interest, and the corporation receives a like amount of interest income.

Fortunately, there is a $10,000 de minimis exception for compensation-related and corporate/shareholder loans that do not have tax avoidance as one of the principal purposes.

Although this transfer of taxable income between entities may appear to be offsetting, there can be a significant tax impact on the re-allocation, depending on the relative tax benefits of the borrower and the lender and the deductibility of the expense deemed paid.

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Downside: Stock or Loan

When IRS examiners review loans from shareholders and the common stock accounts of many incorporated podiatry practices, they frequently encounter something called "thin capitalization." Thin capitalization occurs when there is little or no common stock and there is a

Continued on page 96

Self-Funding *(from page 94)*

large loan from the shareholder. A special section of the tax law, Section 385, specifically considers whether an ownership interest in a corporation is stock or is indebtedness.

The IRS's objective when they encounter thin capitalization is to convert a portion, if not all, of the loans from the shareholders into capital stock. Naturally, this conversion requires an adjustment to the interest expense account because, at this point, the loans are considered non-existent. The interest paid by the incorporated podiatry practice on these disallowed loans becomes a dividend at the shareholder level, equal to the operation's earnings and profits.

Recovering from the Downside, Loans Gone Bad

Under our tax laws, a business bad debt deduction is not available to shareholders who have advanced money to their incorporated practices where those advances were labeled as contributions to capital. A principal, business owner, or shareholder who incurs a loss arising from his guaranty of a loan is, however, entitled to deduct that loss, but only if the guaranty arose out of his trade or business—or in a transaction entered into for profit. If the guaranty is business-related, the resulting loss is an ordinary loss for a business bad debt.

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Sale-Leasebacks

If your podiatry practice is in need of an infusion of cash, but you are reluctant to invest additional money, an answer may lie with the tax benefits. Are the podiatry practice's tax benefits being wasted because of low or non-existent profits? As a result, does the podiatry practice find itself in a low tax bracket?

A one-transaction-cures-all, all-purpose solution involves the sale-leaseback of the assets of your practice. Generally, the practice sells its assets, the building that houses the operation, the equipment used in that operation, or even the fixtures, that are such an integral part of the practice. In return, the practice receives an infusion of working capital. The buyer of those assets, usually using borrowed funds, is often the podiatric professional and principal shareholder—you.

When the principal shareholders in a podiatry practice own the assets of the operation, the practice pays fully tax-deductible lease payments for the right to use those assets in its operation. An unprofitable podiatry practice is exchanging depreciable equipment or its building for badly needed capital and immediate deductions for the lease payments that it is required to make.

The new owner of that equipment, whether the practice's principal, chief shareholder or, perhaps, a trust established for the benefit of the principal's children, will receive periodic lease payments. With one transaction, the podiatrist has found a way to get money from the practice without the double-tax bite imposed on dividends. Even more importantly, the practice has an infusion of badly-needed cash.

A potential pitfall involves the dreaded "passive" income. Unfortunately, under our tax laws, specifically Section 469, Passive Activity Losses and Credits Limited, income from rental real estate is generally considered passive activity income, regardless of the podiatrist's level of involvement in managing the property.

The tax rules clearly state that a taxpayer can use losses from a passive activity only to offset passive activity income. In other words, passive losses cannot shelter other income such as profits, salaries, wages, or portfolio income such as interest, dividend, or annuity income.

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A loophole built into the rules states that rental realty income is not passive activity income if the property is rented for use in a trade or business in which the taxpayer materially participates. This rule prevents taxpayers with passive activity losses from artificially creating passive activity income to absorb the losses.

As mentioned, self-financing is the number-one form of financing used by small business owners. Among the advantages of self-financing is that control is not given to shareholders nor will there be oversight by bankers or other lenders. Disadvantages are that sufficient capital may not be available.

"Me-", or self-financing, is an option, often the only option for many podiatrists in today's economic climate. Drawing on their assets such as savings accounts, equity in real estate, retirement accounts, vehicles, recreational equipment, and collectibles, podiatric professionals, as well as other professionals and small business owners, are increasingly finding the funds needed to fund their practices.

Selling these assets for cash or using them as collateral for a loan, are options. Other "me-," or self-financing options are also available and should be studied, considered, investigated, and acted upon by any podiatrist or podiatry practice in need of funding. **PM**

James D. Krickett is a well-known tax and financial adviser whose columns are syndicated to more than 65 publications each week. His features routinely appear in the pages of leading trade magazines and professional journals.