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Shareholder advances: Debt or equity?

From time to time, owners of closely held businesses might need to advance their companies money to bridge a temporary downturn or provide funds for an expansion or another major purchase. How should those advances be classified under U.S. Generally Accepted Accounting Principles (GAAP)? Depending on the facts and circumstances of the transaction, an advance may be reported as debt or additional paid-in capital.



What are the deciding factors?

When classifying a shareholder advance, it's important to consider the economic substance of the transaction over its form. The accounting rules lay out the following issues to evaluate when reporting these transactions:

Intent to repay. Open-ended understandings between related parties about repayment imply that an advance is a form of equity. For example, an advance may be classified as a capital contribution if it was extended to save the business from imminent failure and no attempts at repayment have ever been made.

Terms of the advance. An advance is more likely to be treated as bona fide debt if the parties have signed a written promissory note that bears reasonable interest, has a fixed maturity date and a history of periodic loan repayments, and includes some form of collateral. However, if an advance is subordinate to bank debt and other creditors, it's more likely to qualify as equity.

Ability to repay. This includes the company's historic and future debt service capacity, as well as its credit standing and ability to secure other forms of financing. The stronger these factors are, the more appropriate it may be to classify the advance as debt.

Third-party reporting. Consistently treating an advance as debt (or equity) on tax returns can provide additional insight into its proper classification.

With shareholder advances, disclosures are key. Under GAAP, you're required to describe any related-party transactions, including the magnitude and specific line items in the financial statements that are affected. Numerous related-party transactions may necessitate the use of a tabular format to make the footnotes to the financial statements more reader friendly.

Why does it matter?

The proper classification of shareholder advances is especially important when a company has unsecured bank loans or more than one shareholder. It's also relevant for tax purposes, because advances that are classified as debt typically require imputed interest charges. However, the tax rules don't always align with GAAP.

To further complicate matters, shareholders sometimes forgive loans or convert them to equity. Reporting these types of transactions can become complex when the fair value of the equity differs from the carrying value of the debt.

Get it right

There isn't a one-size-fits-all solution for classifying shareholder advances. We can help you address the challenges of reporting these transactions and adequately disclose the details in your financial statements. [Contact us](#) for more information.