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Leo Altshuler
(1919-1999)
James J. Brown
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To: Business Owner Clients of Altshuler and Spiro and their Accountants:

From: Bruce J. Altshuler

Date: January 31, 2014

Re: Employee Loans

Dear Business Owner Clients and Accountants:

Over the years, I have noticed that many of my clients have made interest free loans to a few, and in some cases to many - of their employees. Most of these loans are small, many of them have been for several thousand dollars to help certain employees purchase a new home or cover college expenses or pay for a medical emergency.

No, I am not going to tell you never to loan funds to employees, nor do I endorse the practice. Assuming that your business can afford to do this, there are benefits to doing so – humanitarian, to foster employee loyalty and goodwill, and to relieve employees of immediate financial pressures so they can concentrate on their work, not take a second job, or quit.

Obviously, there is also a downside to doing so, and that is the issue of repayment. It is easy enough to set up a written voluntary payroll deduction to allow the loan to be retired over time. But what happens if the employee quits, is fired or dies before the loan is repaid?

More importantly, I have encountered cases over the years where the failure to have the employees authorize the payroll deduction in writing allows the employee's spouse, a sharp attorney or the Labor Commissioner to invalidate the payroll deductions with unfair consequences, easily avoided. Your generosity can be twisted into making you appear to be improperly taking back your employee's wages. Here are some basic rules to follow if you have or are considering or have made employee loans:

(1) **The employee must acknowledge the loan in writing and authorize a periodic deduction from his or her wages;**

(2) Because California is a community property state, **his or her spouse must consent to repayment by a payroll deduction**;

(3) The payroll deduction cannot be greater than 25% of net pay (you probably would never take that much). The amount you take should be enough to retire the loan within a reasonable duration, but not cause a hardship to the employee. Talk to your employee to let him or her suggest the amount of the voluntary deduction within reason;

(4) The deduction cannot leave the gross pay after the voluntary deduction at less than minimum wage;

(5) If the employee departs, under California law, **you cannot repay yourself the final unpaid balance from the employee's last paycheck**. **You can only deduct the agreed upon amount for that paycheck.** The employee remains liable, but that is one of your risks in making a loan – the risk of the employee's death or termination before the loan is fully repaid;

(6) Should you charge interest? Legally, the answer is Yes, but in my experience employers do not generally do so. If you do not charge interest, you should begin to charge some interest on the remaining balance after the employee departs perhaps at 5%;

(7) If you have any doubts about an employee's status with the company, his or her integrity or his or her ability to repay, do not make the loan. If the employee refuses to authorize a payroll deduction, do not make the loan. Do not make loans to marginal or unreliable employees;

(8) If you decide to forgive or write off a loan, be aware that this generates taxable income to the employee. In that case, your CPA will advise you on the reporting requirements;

(9) You should document loans to your key executives in the same fashion as loans to lower level employees; and

(10) Your company is not a bank or a charitable institution. Do not overdo employee loans, as they might impact your balance sheet and leave you with uncollected debts. If you make an exception for one or a few employees, you are not obligated to provide free loans to other employees. Remember, these are unsecured loans, easily dischargeable in bankruptcy.

If you have existing undocumented employee loan(s) on your books, we can easily fix the legal problem by preparing a repayment agreement, a spousal consent, and a letter of explanation for the employee borrower.

Contact us so we can provide you with forms you can use indefinitely each time an employee loan arises. For the CPA recipients, check with your clients on this issue.

Regards.

BRUCE J. ALTSHULER