

INTEREST FREE LOANS

This letter focuses on up-front planning that's necessary to avoid unexpected-and generally adverse-tax consequences when you make loans to relatives. The same considerations apply in the context of loans made to friends.

Your Loan's Interest Rate and the AFR

In most cases, loans between family members are "below-market loans." By that we mean they charge either no interest or a rate below the government's "applicable federal rate" or AFR. The AFR is very important, because it's the minimum rate you can charge without creating unwanted tax "side effects." The IRS publishes AFRs monthly in the Internal Revenue Bulletin. The relevant AFR for a particular loan is the one in effect for loans of that duration for the month the loan is made.

For example, say you made a loan in June of 2000. The AFR for a short-term loan made that month (term up to 3 years) was 6.35% with monthly compounding; the AFR was 6.42% for mid-term loans (more than 3 and up to 9 years), and it was 6.21% for long-term loans (over 9 years). Once the AFR is determined, it continues to apply over the life of the loan—regardless of how interest rates may fluctuate during that time. (The exception is demand loans, for which the AFR is redetermined annually by "blending" the monthly short-term AFRs for that year.)

As you can see, the AFRs are lower than the rates charged by commercial lenders. However, as long as you charge at least the AFR on a loan to a family member (or friend), you don't have to worry about any of the income tax and gift tax complications that we will spend the rest of this letter explaining.

For example, say you make a four-year loan in June of 2000 and charge at least 6.42% interest compounded monthly (the AFR for mid-term loans made during that month). You can ignore the remainder of this letter. If you want to charge less than 6.42%, please keep reading.

Charging at least the AFR will keep things simple. You will have taxable interest income equal to the stated interest rate, and the borrower will have an equal amount of interest expense (which may or may not be deductible, depending on how the loan proceeds are used). However, most loans to relatives don't charge any interest, or only a

nominal amount. In these cases, you must do a little planning to keep the IRS off your back. More on that subject later.

Be Sure to Get Your Loan in Writing

Regardless of the interest rate you intend to charge (if any), you'll want to be able to prove you intended the transaction to be a loan rather than an outright gift. Why? Because if worst comes to worst, you'll want to claim a "nonbusiness bad debt deduction."

Losses from nonbusiness bad debts are considered short-term capital losses. They are valuable because they can offset your capital gains. If your nonbusiness bad debt loss exceeds your capital gains for the year, you can generally deduct up to \$3,000 of the excess against your income from all other sources (salary, dividends, etc.). Any remaining loss gets carried forward to next year and will be subject to the same rules next year.

Without a written document, your intended loan will probably be recharacterized as a gift by the IRS if you get audited. Then if the loan goes bad, you won't be able to claim any nonbusiness bad debt loss deduction. Also, if your intended loan is over \$10,000 and is recharacterized as a gift, you'll either owe federal gift tax or burn up part of your \$675,000 gift and estate tax exemption. This could result in higher gift or estate taxes down the road.

To avoid these problems, your loan should be evidenced by a written promissory note which includes the following details:

- ◇ The interest rate if any,
- ◇ A schedule showing dates and amounts for all interest and principal payments, and
- ◇ Security or collateral for the loan, if any.

Make sure the borrower signs the note. If your relative will be using the loan proceeds to buy a house and you are charging interest, be sure to have the note legally secured by the residence. Otherwise your relative can't deduct the interest as qualified residence interest.

At the time you make the loan, it's also a good idea to write a memo to your tax file documenting reasons why it seemed reasonable to think you will be repaid. Again, this supports your contention that the

transaction was always intended to be a loan rather than an outright gift.

Finally, if you keep written financial records—such as a personal balance sheet—be sure you show a “loan receivable” on the asset side of your ledger. Then do the necessary bookkeeping to track interest and principal payments and reductions in the loan balance.

Tricks of the Trade for Below-Market Loans

As we explained earlier, life is fairly simple if your loan will charge an interest rate that equals or exceeds the AFR. But if you charge less, you’ll have to finesse the tax rules to avoid unpleasant surprises. Here’s what you need to know.

When you make a below-market loan to a relative, the Tax Code treats you as making an “imputed gift” to your borrower. The imaginary gift equals the difference between the AFR interest you “should have” charged and the interest you actually charged, if any.

The borrower is then deemed to pay these phantom dollars back to you as “imputed interest.” Although this is all fictional, you must still report the imputed interest as taxable income on Schedule B of your return. (The resulting extra taxes are *not* fictional.)

To make matters worse, when your imputed gift to the borrower exceeds \$10,000, you’ll owe gift tax if you’ve exhausted your \$675,000 exemption. That’s on top of the income tax hit from the imputed interest. Even if you don’t owe any current gift tax, an imputed gift over \$10,000 will use up part of your \$675,000 exemption, which may mean higher gift or estate taxes later on.

The good news is you can usually avoid all these negative tax outcomes, but it takes some planning. Here’s how to take advantage of the two big loopholes that Congress left open for people like you.

Loophole #1: “The \$10,000 Rule”

For small loans, the IRS lets you ignore the imputed gift and imputed interest income rules. However, to qualify for this loophole, any and all loans between you and the borrower in question must aggregate to \$10,000 or less. If you pass this test, you can forget all the nonsense about imputed gifts and deemed interest. Beware: The \$10,000 aggregate loan limit applies to all outstanding loans between you and

the borrower, whether or not they charged interest equal to or above the AFR.

For example, say you make a \$10,000 interest-free loan to your son. If this is the only loan you have made to him, you can take advantage of the \$10,000 rule. That means there are absolutely no tax consequences for either you or your son. So far, so good. However, if you later make a second loan to your son while the first one is still outstanding, those nasty imputed gift and interest rules will kick in for any portion of the loan(s) not charging at least the AFR. This is the case even if the second loan charges a market rate of interest. In addition, even if the total loans outstanding don't exceed \$10,000, this exception to the imputed interest rule doesn't apply if the loan allows the borrower to acquire or continue to carry income-producing assets.

Loophole #2: "The \$100,000 Rule"

Obviously, the \$10,000 rule is no help with bigger loans. Fortunately, the \$100,000 rule will keep you out of trouble in most cases. You are eligible for the \$100,000 rule as long as the aggregate balance of all outstanding loans (below-market or otherwise) between you and the borrower is \$100,000 or less.

First let's cover how the \$100,000 rule works for income tax purposes. Then we'll explain the gift tax consequences.

For income tax purposes, the taxable imputed interest income to you is zero as long as the borrower's net investment income for the year is no more than \$1,000. (Net investment income is the same figure used to determine how much broker margin account interest can be deducted on one's Schedule A.) If the borrower's net investment income exceeds \$1,000, your taxable imputed interest income is limited to no more than his or her actual net investment income. The borrower must give you an annual signed statement disclosing his or her net investment income for the year. Be sure to keep this document with your tax records.

For example, say you make a \$100,000 interest-free loan to your daughter, who has \$500 of net investment income for the year. Your taxable imputed interest income is zero. If your daughter's net investment income is \$1,200, your taxable imputed interest income is the lesser of \$1,200 or the actual imputed interest. In most cases, the borrower will have under \$1,000 of net investment income, so you will usually have zero taxable imputed interest income under these rules. [If one of the principal purposes of the loan is tax avoidance, all bets

are off. This exception to (or limitation on) the imputed interest rules doesn't apply.]

OK. So far, so good. Unfortunately, the gift tax results under the \$100,000 rule are really tricky. (The net investment income rule we just explained is inapplicable in the context of gift taxes.) However, there's still a way to keep things simple.

You should designate your below-market or interest-free loan as a "demand loan." This means you can legally demand full repayment anytime you want, even though you and the borrower may have informally agreed on a payment schedule. With a demand loan, the imputed gift amount is calculated year-by-year and is equal to the imputed interest for that year. As long as interest rates remain anywhere close to today's rates, the annual imputed gift will be well under the \$10,000 annual limit for tax-free gifts. (For purposes of computing each year's imputed gift amount, you use the "blended" short-term AFR for that year, as published by the IRS.)

Based on current interest rates, the annual imputed gift on a \$100,000 interest-free demand loan would only be about \$6,000. So unless you make other gifts to the borrower totaling about \$4,000 or more during the year, your interest-free loan will have absolutely no gift tax consequences.

In contrast, when you make a below-market or interest-free "term loan," the gift tax rules are much less favorable. Say you make a \$100,000 interest-free loan calling for a balloon repayment after seven years. This is a term loan (so is a loan calling for installment principal payments). As such, you're treated as making an immediate imputed gift to the borrower equal to *seven year's worth of imputed interest*.

On a \$100,000 term loan, your imputed gift in the year the loan is made will be well in excess of the \$10,000 annual tax-free limit. So you'll either owe current gift taxes or burn up part of your \$675,000 exemption. As we just explained, however, you can easily avoid both of these adverse outcomes simply by making a demand loan instead of a term loan. You and the borrower can still informally agree on a seven-year balloon repayment arrangement, if you wish—as long as you contractually retain the right to call the loan at any time.

Conclusions

As you can see, there are tax complications when you make loans to family members (or friends for that matter). However, you can

generally avoid all the pitfalls by carefully planning and documenting your transactions. We are always available to assist you in this regard. Please call if you have questions or want more information.