

Tax Action Memo®

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Client Letter on Arranging Tax-smart Loans to Family Members

<p>Type of Clients: Individuals.</p> <p>Situation: Your client is considering making a loan to a family member (or friend).</p> <p>Deadline: Before the deal is done.</p>	<p>Tax Action Required: Use or adapt the attached sample client letter on how to make tax-smart family loans.</p>
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Background

In these tough economic times, some of your clients may want to help out a financially stressed relative by loaning that person some money. That is commendable, but, as you well know, it's important that any loans they make be *tax-smart* loans.

To help you alert your clients to the upfront planning needed to avoid unexpected (and generally adverse) tax consequences of loaning money to a relative or friend, we've included a sample letter with this release. As a subscriber to this newsletter, you may edit and distribute the letter to clients, potential clients, and referral sources as you see fit. However, please remember that the material is copyrighted. You may not use it for any other purpose, such as posting it on a website area available to the public or sharing it with another firm or association of firms of which you're a member.

To download the letter, go to <http://ppc.thomson.com/subscriptions/tabn>. (Check the top of the first page of the most recent *Tax Action Memo* you've received for the current PTAB user name and password.) At the PTAB Online Resource Center, click on "Sample Client Letters."

References: The relevant guidelines for below-market gift loans and demand loans to family members and friends are found in IRC Sec. 7872; Prop. Regs. 1.7872-1, -2, -3, -4, -6, -7, -8, -10, -11, -12, -13, and -14; and Prop. Regs. 20.7872-1 and 25.7872-1. Note that we are *not* talking here about the imputed interest concept as defined under the Section 1274 original issue discount rules or as defined under the Section 483 unstated interest rules, both of which generally relate to loans made in connection with sales of property.

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

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Appendix 1

Sample Client Letter on Arranging Tax-smart Loans to Family Members

Dear Client:

In these tough economic times, you may want to help out a financially stressed relative by loaning that person some money. That is commendable, but please make it a *tax-smart* loan. This letter explains the upfront planning needed to avoid unexpected (and generally adverse) tax consequences when you loan money to a relative. The same considerations apply if you're considering a loan to a friend.

Your Loan's Interest Rate and the AFR

In many cases, loans between family members are *below-market* loans. By that we mean they charge either no interest or a rate below the 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. For *term loans* (those with specified repayment dates), the relevant AFR is the rate in effect for loans of that duration for the month the loan is made. Right now AFRs are very low, so making a loan that charges the AFR instead of a lower rate or a 0% rate makes a lot of sense. Why? Because you can give the borrowing relative a good deal on the interest rate without causing any tax complications for yourself.

Here's what we mean. Say you make a term loan to a favorite relative in May of 2009. For a short-term loan (one with a term of three years or less) made that month, the AFR is an incredibly low .76% (assuming monthly compounding). The AFR for a midterm loan (over three years but not more than nine years) is only 2.03%. The AFR for a long-term loan (over nine years) is only 3.52%. The same AFR continues to apply over the life of the loan—regardless of how interest rates may fluctuate during that time. As you can see, the quoted AFRs are way 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 much of the rest of this letter explaining.

For example, say you make a five-year term loan in May of 2009 and charge exactly 2.03% interest compounded monthly (the AFR for midterm loans made during that month). You will have taxable interest income based on that same rate for the life of the loan, 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). Tax-wise, that's all you need to know about the interest rate. So if you want to charge the AFR, you can ignore most of the rest of this letter. However, if you insist on charging less than the AFR, you will have to keep reading. (For loans made after May 2009, contact us for the current AFRs because they change every month.)

Note: If you make a *demand loan* (one that you can call due at any time) instead of a term loan, the AFR for each year will be a blended rate that reflects monthly changes in the short-term rate. Therefore, with a demand loan, the annual AFR can change dramatically—depending on how general interest rates move. This creates uncertainty that both you and the borrower probably would prefer to avoid. Making a term loan that charges at least the current AFR will avoid the uncertainty.

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 the worst happens, you'll probably 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, self-employment income, interest, dividends, and so on). 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 \$13,000 and is recharacterized as a gift, you'll either owe federal gift tax (unlikely) or burn up part of your federal gift and estate tax exemptions (more likely). The latter 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 that includes (1) the interest rate, if any; (2) a schedule showing dates and amounts for all interest and principal payments; and (3) security or collateral for the loan, if any.

Make sure the borrower signs the note. If your relative (or friend) 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 would 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. If you have questions about these details, we can help.

Tax Rules for Below-market Loans

As we explained earlier, the tax results are very straightforward if your loan will charge an interest rate that equals or exceeds the AFR. If you insist on charging less or nothing, 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 (one that charges an interest rate below the AFR), the Tax Code treats you as making an *imputed gift* to the 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 your Form 1040. The resulting tax hit is *not* fictional. When your imputed gift to the borrower exceeds \$13,000 for the year, it can also have adverse gift and estate tax consequences.

The good news is you can usually avoid these negative tax outcomes for below-market loans, but it takes some planning. Here's how to take advantage of two big loopholes in the Tax Code.

The \$10,000 Below-market Loan Loophole. 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 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, and there will be no federal tax consequences for either you or your son.

Note: You cannot use this \$10,000 loophole if the borrower uses the loan proceeds to buy or carry income-producing assets.

The \$100,000 Below-market Loan Loophole. Obviously, the \$10,000 rule is no help with bigger loans. Fortunately, the \$100,000 rule will keep you safe in most cases. You are eligible for the \$100,000 rule as long as the aggregate balance of all outstanding loans (with below-market interest 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. If the borrower's net investment income exceeds \$1,000, your taxable imputed interest income is limited to 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 imputed interest income that is taxable is zero. If your daughter's net investment income is \$1,200, your imputed interest income that is taxable is limited to \$1,200. 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.

Simple enough. Unfortunately, the gift tax results under the \$100,000 rule are 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. Here's how.

Designate the 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 informally agree 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 AFRs remain anywhere close to today's low rates, the imputed gift for each year will be well under the \$13,000 annual limit for tax-free gifts, which means there will be no gift tax consequences. (For purposes of computing each year's imputed gift amount, you must use the blended short-term AFR for that year, as published by the IRS.) For instance, based on current AFRs, the annual imputed gift on a \$100,000 interest-free demand loan would only be around \$1,000. Unless you make other gifts to the borrower totaling more than about \$12,000 during the year, your interest-free loan will have no gift tax consequences.

In contrast, if you make a below-market or interest-free *term loan*, the gift tax consequences could be problematic (especially if AFRs when you make the loan are higher than now, which is very possible). Say you make a \$100,000 interest-free loan calling for a balloon repayment after eight 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 eight year's worth of imputed interest at the current midterm AFR. On a \$100,000 loan, the imputed gift amount could be well in excess of the \$13,000 annual tax-free limit. So you'll either owe current gift taxes (unlikely) or burn up part of your federal gift and estate tax exemptions (more likely). As we just explained, however, you can avoid any such adverse tax outcomes simply by making a demand loan instead of a term loan. You and the borrower can still informally agree on an eight-year balloon repayment deal, if you wish.

Conclusion

As you can see, there are potential tax complications when you are nice enough to make a loan to a family member (or friend). But, you can avoid the pitfalls by carefully planning and documenting your loan transaction. We are always available if you need some help. Please contact us if you have questions or want more information.

Very truly yours,