

Intra-Family Loans: Sidestep Tax Traps

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If your child is graduating from college or grad school, you'll want the youngster to start off on the right foot. For instance, John or Susan might need seed money for a business start-up or to help pay the first-year's rent in their new digs.

Strategy: Give your child a low-interest, or even a no interest, loan. As long as you stay within the tax law boundaries, your family will have no worries. However, if you're not careful, you could wind up facing tax complications.

With the interest rates on the low side, this may be a good time to arrange a loan from a gift tax Prospective (see note at bottom)

Here's the whole story: The Tax law discourages intra-family loans where the lender doesn't charge any interest or charges interest at a below-market rate. In brief, interest income may be imputed to the lender under a three step process:

1. You're treated as having charged interest to the borrower.
2. You're then treated as making a gift of the interest amount to the borrower.
3. The borrower is then deemed to use the gift to pay the interest amount to you, and you must report that deemed interest income on your tax return.

In other words, you're stuck with a tax bill on interest income, even though you never actually received a penny of interest. This is sometimes referred to as "phantom income" by tax pros.

Fortunately, there are two ways to avoid this harsh tax result for intra-family loans.

1. Keep the loan amount below \$10,000. There's a de minimis exception in the law for loans totaling \$10,000 or less, as long as the loan is not directly attributable to the purchase or carrying of income-producing assets.

2. Set the loan amount below \$100,000. For loans totaling \$100,000 or less, the amount of interest you're treated as receiving annually for tax purpose is limited to the borrower's net investment income for the year. And, if the borrower's net investment income doesn't exceed \$1,000. (Which it probably won't), there's no taxable interest income on a 0% intra-family loan.

Note that the \$100,000 exception does not apply if you charge a below- market level interest rate for tax avoidance purposes.

The IRS can be especially tough on loans reputedly made for business purposes. For instance if you can't present "clear and convincing" evidence that the loan is tied to a business transaction, it may be deemed a

gift. In that case, you're not entitled to any tax benefits if the loan isn't repaid. Sometimes, discretion is the better part of valor.

Alternative approach: Instead of giving your child a low-interest or no-interest loan, charge the child the IRS-approved interest rate using the following link to the IRS' federal rates charts:
<http://www.irs.gov/app/picklist/list/federalRates.html>

In addition, spell out in writing the key elements of the loan agreement, including the amount, the time for repayment and the designation of collateral. Finally, have the loan document witnessed and notarized.

As a result, you'll have proof on your side if the transaction is ever challenged by the IRS. Make sure all the i's are dotted and the t's are crossed. What happens if your child can't pay back the loan? For a personal loan, the loss is treated as a short-term capital loss when it becomes totally worthless (i.e., there's no reasonable prospect for payment). So, you can use the loss to offset capital gains realized during the year, plus up to \$3,000 of ordinary income.

Tip: For a loan that is made in connection with your business, the full amount of the loss may be used to offset highly taxed ordinary income (e.g., your salary).

Note: How Low can you go? – No gift tax is imputed on an intra-family term loan if you charge an interest rate at least equal to the applicable Federal Rate (AFR) for the month the loan is made. Frequently, the loan will be structured so your child or other relative makes monthly interest payments with a principal balloon payment at the end.

Alert: The IRS treats loans as either short-term loans (loans of three years or less), Mid-term loans (loans over three years but not over nine years).

Currently, the AFR rates are at near record lows, although they started to inch back up a few months ago. The rates for each loan category so far in 2011 are available in the link attached above.