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TRUSTS AND ESTATES LAW

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Intrafamily Loans—Utility Remains

For many years prior to 1984, a high-income taxpayer could loan money to a lower-income tax payer without charging interest on the loan and the loan terms would be respected on their face.

For example, a parent could loan money to his or her child without charging interest. The child would consequently have use of the money without the requirement of paying interest back to the parent. The child could use that money to invest in income producing assets. The child could earn income, which would be taxable to the child at his or her lower income tax rate and the parent would earn no income on the loan because there would be no interest charged to the child.

Had the property or the money been invested in the parent's name, the total family income tax would be higher. This translated to a great opportunity for a parent to minimize his or her own income tax and at the same time benefit their child who may have wished to use the money without paying for the use of that money.

Generally, the loan would take one of two forms. In exchange for the loan, the borrower

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would either execute a promissory note which provided that the borrower would make periodic payments over a term certain (a "term loan") or the borrower would repay the money to the lender upon the demand of the lender (a "demand loan"). In both types of loans, since the borrower did not need to pay interest to the lender, having the use of the money for the period the loan was outstanding would benefit the borrower. In many cases, a demand loan was preferred because of the flexibility and the lack of periodic payments the borrower was required to make.

IRS Attacks Producing Limited Success

The Internal Revenue Service (IRS) perceived that a lender employing this technique was underpaying the tax that should rightfully be paid to the government. Consequently, the IRS attempted to curtail the use of this technique by claiming that the interest-free demand loan was a gift of money, to wit: the interest not charged by the lender. However, the courts did not agree with the IRS. The IRS was successful in attacking loans for a term certain when the note did not charge the prevailing rate of interest. The difference between the amount borrowed and the value of the note was considered a gift. Further, the IRS attempted to deem that the borrower owned income on the amount that he or she borrowed.

The IRS was similarly not successful with this line of attack. Therefore, a demand loan by a high-income taxpayer to a low-income taxpayer would permit the borrower to pay a lower tax simply by applying his lower tax rate to the same income that would have been earned, theoretically, on that money if the income had been earned by the lender. Further, that income could have been substantial before 1984, as interest rates were very high and returns on investments may have been robust.

Needless to say, there was a lot at stake for high net worth families employing the technique.

'Dickman v. Commissioner'

In 1984 the Supreme Court in *Dickman v. Commissioner*, 465 US 330, dealt a painful blow to the use of this technique. It held that a loan without sufficient interest produces a taxable gift from the lender to the borrower. Further, also in 1984, Congress wasted no time in passing Internal Revenue Code (IRC) §7872. Section 7872 was designed to not only cause a taxable gift as a result of employing the technique, but also taxable income.

The statute distinguishes between those loans that have a stated term ("term loans") and those that do not ("demand loans"). Loans (Term and Demand) in which the Applicable Federal Rate exceeds the charged rate are called below-market loans. The statute also provides the framework for a tax fiction in which the forgone interest is deemed transferred by the lender to the borrower, and then retransferred by the borrower to the lender as interest, even though no payments were actually made. Further, the deemed gift must be computed for both gift and income tax purposes to determine the amount. The lender may mitigate the effect of the gift by using any available annual exclusions.

For a demand loan, the interest is computed daily on the outstanding balance. The deemed gift is made for the amount computed above on the last day of the tax year. This deemed gift is the same for income and gift tax purposes. For a term loan, the computation and timing of the deemed gift for gift tax purposes is the same as for a demand loan. However, for a term loan, the income tax consequences are different with regard to the computation and timing. Specifically, the date the loan is made is the date of the deemed gift in the amount of the difference between the present value of all loan payments computed using IRS regulations and the value of the cash and other property, if any, transferred in the exchange.

There are a few limited exceptions to the imputed interest rules detailed above relating to gift loans, which are loans for which the forgone interest is in the nature of a gift, rather than compensation or some other nature. First, a de minimis exception is available. The statute provides that a loan of $10,000 or less between individuals only—an entity may not be a party to the loan—does not require the imputation of interest if the amount of the outstanding balance of the loan does not exceed $10,000 at any time. In the event that the balance of the loan does exceed $10,000, then interest is imputed daily beginning on the date the loan balance increases above $10,000. A husband and wife are treated as one person for this exception. This exception is unavailable if the loan is attributable to the acquisition of income-producing assets.

Another exception includes a safe harbor. A loan between individuals, as under the $10,000 exception, does not require the imputation of interest if the amount of the outstanding balance of the loan does not exceed $100,000 at any time. This exception applies only when the borrower's and his or her spouse's net investment income for the year (gross income from taxable interest, dividends, rents, royalties, and gains from investment assets, reduced by investment expenses) does not exceed $1,000. Trade or business income is not included in net investment income. The amount of the borrower's and spouse's net investment income, if under $1,000, is ignored.

A safe harbor is a loan between individuals, which, under the $10,000 exception, does not require imputation of interest if the outstanding balance of the loan never exceeds $100,000.

However, if the net investment income of the borrower and his or her spouse exceeds $1,000, the amount of the net investment income is imputed to the lender. This limitation prevents income shifting from a higher-income lender to a lower-income borrower. Further, once the $1,000 limit is exceeded, the gift tax will apply to the income. Use of the lender's available annual exclusions can reduce or eliminate the gift tax. One additional constraint for the $100,000 exception: if one of the principal purposes of the interest arrangement is federal tax avoidance, then the exception does not apply.

Since a loan under $100,000 could subject the lender to income and gift tax if the borrower's and his or her spouse's income is too high, planning for the borrower's net investment income may make a difference. One way for the borrower to reduce his net investment income is to use the loan proceeds to purchase tax-exempt investments, such as municipal bonds, as the definition of net investment income does not include tax-exempt income. However, if the borrower can alter the timing of the receipt of the net investment income, then the $100,000 exception does not apply. This may occur if the borrower owns a controlling stake of a closely held corporation and dividends may be paid at the discretion of the shareholders. Another way to keep net investment income low is for the borrower to purchase nonincome-producing assets. The borrower's purchase of a personal residence may produce no net investment income. Finally, the low interest rate environment in which we live makes it a bit easier to keep the borrower's net investment income low as well.

Conclusion

While the rules under *Dickman* and §7872 have drastically reduced the utility of these gift loans, with a little careful planning, the lender may be able to assist a borrower without causing a taxable event to himself or herself.