

# THE RISELING REPORT . . . . .

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## **GIFT LOANS— HEY DAD, CAN I "BORROW" \$50,000?**

Our children often ask us to "loan" them money. Unfortunately, the income and gift tax rules are complicated. With few exceptions, you must charge interest on loans--even so-called "gift loans". Here are the rules:

### **WHAT IS A GIFT LOAN?**

Section 7872(f)(3) of the Internal Revenue Code of 1986 states that "a gift loan" is any loan where the interest charged is none or is below what the IRS says you should charge ("market rate")--where the foregoing of interest is a gift. For example, a gift loan includes a below-market rate (or interest free) loan from a parent (lender) to a child (borrower). The loan need not be intra-family; loans between unrelated persons may also be gift loans.

### **INCOME TAX RAMIFICATIONS**

If a parent loans a child money without interest or with an interest rate "below the market", on December 31 of each year, there will be two "deemed transactions".

1. First, an amount equal to the foregone interest is deemed to have been transferred from lender (parent) to borrower (child). The foregone interest is equal to the difference in the interest computed using the market rate of interest as determined by the Internal Revenue Service and the actual interest charged by the lender for that period. The market rate of interest determined by the IRS is known as the **Applicable Federal Rate** and is adjusted monthly. AFR for January 1995 was 7.07% and 8.01% for demand loans and term loans, respectively.

2. Second, after the transfer from the lender to the borrower (i.e., the gift) it is deemed that the borrower (child) paid interest back to the lender (parent). **The lender (parent) is treated as having received interest income equal to the foregone interest. Lender must pay income tax on this!** The borrower (child) is treated as having paid interest, which may be deductible if related to a business, a residence or an investment--otherwise it is non-deductible.

## **GIFT LOANS NOT EXCEEDING \$10,000**

Code Section 7872(c)(2) provides that in the case of any gift loan directly between individuals, the imputed interest rules **shall not apply to any day on which the aggregate outstanding amount of loans between such individuals does not exceed \$10,000**. In other words, a parent may loan \$10,000 to his child and the imputed interest rules don't apply!--No gift or income tax consequences.

## **SPECIAL "INCOME TAX" RULE FOR LOANS \$100,000 OR LESS**

Code Section 7872(d)(1) provides a special rule where loans to an individual do not exceed \$100,000. This special treatment for loans of \$100,000 or less **does not apply** to any loan made by a lender (parent) to a borrower (child) for any day on which the aggregate outstanding amount of loans between the borrower (child) and lender (parent) **exceeds \$100,000**. For purposes of **income** tax, in the case of a **gift loan** directly between individuals, the amount treated as re-transferred by the borrower (child) to the lender (parent) as of the close of any year shall not exceed the borrower's (child's) **net investment income for such year**. Generally, net investment income includes the gross income from property held for investment and certain gains from the sale of property. If the child's net investment income for any year does not exceed \$1,000, the child's net investment income for such year is treated as zero. Accordingly, if a parent loans a child \$100,000 which the child uses to buy a house and the child does **not** have net investment income of more than \$1,000 during a year, then there would be no imputed interest income back to the parent for that year. However, there would be a gift.

## **A PROBLEM--FAMILY ATTRIBUTION**

Code Section 7872(f)(7) states that for purposes of imputing interest, husband and wife **shall be treated as one person**. This means husband and wife **cannot** take advantage of the de minimus \$10,000 rule or the special \$100,000 rule **where the combined loans from husband and wife exceed \$10,000 or \$100,000, respectively, to the borrower**. Also, a lender cannot double the benefits of the \$10,000 or \$100,000 special treatment by making loans to a borrower's spouse.

## GIFT TAX RAMIFICATIONS

For Federal Gift Tax purposes, the amount of foregone interest (imputed interest) that the lender must treat as a gift to the borrower depends upon the type of loan involved. If a loan is a **demand** loan, the lender is deemed to have made a cash transfer to the borrower of the annual foregone interest on the last day of the year. There can be potential annual gift tax consequences if the demand loan continues beyond one calendar year. If a **term** loan is used, the lender is deemed to have made a cash gift of the foregone interest to the borrower on the date when the loan is made. The excess of the amount loaned over the present value of all payments that are required to be made under the terms of the loan is a gift. Since the amount is deemed to be transferred on the date of the loan, there will only be one potential taxable gift in a term loan situation. In other words, a demand loan will have periodic gifts while a term loan will have a gift at the front end of the term of the loan. Remember, the \$100,000 special rule does not apply for gift tax purposes, only income tax purposes.

The foregoing summarizes the income tax and gift tax implications of the use of loans that have a stated interest rate of zero or below the market. If you have any questions, please feel free to call our office.

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