Should you be a bank?

One of your children is starting a new business. Or looking to purchase a first home but coming up short for the down payment. Or needs assistance with a child's college education.

In some cases you may be reluctant. But very often your instinct will be to say, "Yes, of course." But don't go into the transaction blindly. Failing to follow formalities can have negative consequences that you may not have foreseen.

What's the purpose of the loan?

If you have any doubts about how the loan proceeds will be used or are concerned about repayment, having your child apply for a bank loan may be a good first step. An objective judgment about the child's creditworthiness allows you to make an informed decision about whether or not to make the loan.

Presuming that the money will be used for an appropriate endeavor, why not just make a gift instead? It's an option, but when there is more than one child, there may be the perception of unequal treatment (even though bequests can be adjusted to account for a lifetime gift). Another consideration, especially if the amount of assistance needed is substantial, will be the impact of federal gift tax.

Structuring the loan

Formalities bring structure and seriousness to the transaction. The former will help to eliminate tax complications. The latter avoids any later misunderstandings or the anticipation that the loan need not be repaid or will be forgiven.

A well-drawn loan agreement (promissory note) includes several elements: the amount of the loan, a clearly articulated repayment schedule (with dates) and a stated rate of interest. The document should be dated and signed by all parties.

If the loan is for the purchase of a home, your child will want the income tax deduction for the interest paid on the debt. For the deduction to be available, the note should identify the home clearly and state that it is serving as collateral. Record the promissory note on the land records so that in the event of default, the home will pass to you ahead of other creditors.

The issue of interest

There are tax implications if you don't charge interest for the loan, or charge interest at a below-market rate. In these instances interest is "imputed." The amount of the imputed interest is potentially taxable income to the lender, and you will be treated as if you had made a gift to the borrower of the amount of the forgone interest.

What's the right interest rate to charge in order to avoid these problems? The IRS has established three minimum loan rates ("Applicable Federal Rates," or AFRs), based upon the length of the loan. These are: the annual short-term rate (three years or less); the annual mid-term rate (more than three years but less than nine); and the annual long-term rate (more than nine years). These rates change monthly.

The imputed-interest rules are complex and riddled with exceptions. For instance, loans of $10,000 or less may be exempt from the rules (generally speaking, when the loan proceeds are not used to buy income-producing assets). An exception for loans of $100,000 or less is more complicated and is keyed to the borrower's net investment income.

Recommendation: Talk to a tax expert if you plan to make a loan and charge less than the going rate of interest.

But what if . . .

If your child has financial problems later, you may want to forgive the indebtedness and claim an income tax deduction for your loss.

Many tax experts recommend that, when you draft the promissory note, you should create an additional document. This document should include language that states that, to the best of your knowledge, your child was solvent at the time that the note was drafted and that you fully expect to be repaid. This added ammunition will help support the deduction in the event of an IRS audit.

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Any developments occurring after January 15, 2007, are not reflected in this article.