

When Is A Loan Better Than A Gift?

Eager to give the children a financial head start, parents often provide cash for a down payment on a home or to launch a business. If the money is a gift, gift-tax rules apply. A less straightforward approach—making an interest-free loan—might be an appealing alternative. But you'll need to abide by a separate set of arcane tax rules.

For gifts, there are two tax-exempt amounts to keep in mind. First is the annual exemption, which permits anyone to give up to \$11,000 annually to an unlimited number of recipients without gift-tax liability. Spouses filing jointly may together provide \$22,000 a year. If you exceed those amounts, the excess counts against a \$1 million lifetime exemption.

Suppose your daughter needs \$100,000 to invest as a partner in a restaurant start-up. If you and your spouse gave her the money, your annual exemptions would take care of \$22,000, and the rest would reduce your lifetime caps. But what if you made an interest-free loan instead of a gift?

For loans, the Internal Revenue Service normally acts as if interest is paid, even when it's not. So if you give your daughter a no-cost loan, you could end up paying income tax on the interest the IRS thinks you should have received. To establish the amount of this imputed or forgone interest, the IRS uses the applicable federal rate (AFR), which it updates each month. You might also be liable for gift tax on the money the IRS assumes you gave her to pay that phantom interest.

Yet special exemptions for loans could help you avoid such problems. For starters, you can lend a total of \$10,000 to a borrower without running afoul of IRS rules. Beyond that, you may be allowed to make a loan of up to \$100,000 without triggering a tax bill for forgone interest. The \$100,000 exemption applies as long as your daughter earns no more than \$1,000 in net investment income (from interest and short-term capital gains) during a particular tax year. If she gets more than \$1,000 from investments, you'll owe tax on her total investment income, up to the amount of the forgone interest according to the AFR.

On a loan of less than \$100,000, you'll still be liable for gift tax to pay the forgone interest. But at the AFR recently in effect, yearly interest on a loan of \$100,000 would amount to only about \$4,000—well within your annual exemption.

Why would you take the trouble to make a loan instead of a gift? You might want to be repaid, either to foster a sense of responsibility in your child or because you need the money. Moreover, you may prefer to preserve your lifetime gift-tax exemption for estate planning purposes.

Estate planning and gifting strategies are complex. Please call us if you have a question about your strategy and whether a making a loan to your children would be advantageous to you.