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## **If you're going to loan money, draw up some papers**

Proper documentation is critical when loaning money to friends or family. Without appropriate recordation of the loan, the IRS may consider the transaction a gift, thereby potentially exposing the person funding the loan to a reduction in his or her lifetime gifting exemption, currently set at \$1 million. And although a loan to a friend or family member should always be completed in a professional manner, such a loan nonetheless may provide consolation to both parties to the transaction, insofar as the loan may provide liquidity when credit might otherwise be unavailable, and insofar as interest payments ultimately will remain within the friends or family dynamic.

Proper documentation of the loan will involve a writing, typically a note (a promise to pay), setting forth the loan amount, the expected date of payment, and an interest rate (compensation to the lender for the use of the borrowed money). Without a stated rate of interest, the IRS would have greater footing in treating the transaction as a gift; additionally, it may contend that the lender is deemed to have received interest, which the lender then gave back to the other party to the loan transaction. The "deemed" interest would then need to be reported as interest income by the lender, even though he or she never actually received it. Furthermore, if the interest actually charged by the lender is below the normal going rate, known as the applicable federal rate (or AFR), the IRS may consider the difference between the interest charged and the AFR as "foregone interest", which again would then need to be reported as interest income by the lender. Note that the AFR is determined by the length of the loan, segregated into short, mid, and long-term obligations. Applicable federal rates are published by the IRS each month in the Internal Revenue Bulletin, which are available on the IRS website at [www.irs.gov/irb](http://www.irs.gov/irb).

(Note that several exceptions to the below-market interest rate loan rules described above, chief among which is that the rules do not apply to loans of \$10,000 or less, where the loan is between individuals and the proceeds are not directly used to buy income-producing assets such as stocks or bonds. Other exceptions are more complicated. Advice from a tax professional is urged.)

Lastly, consideration may be given to securing the loan, which occurs when a borrower pledges an asset such as a motor vehicle or real property as collateral for the loan; in the event that the borrower defaults on his or her loan obligation, the lender can take possession of the asset and sell it to satisfy the debt. By extending the loan on a secured basis, the lender is relieved of most of the financial risks involved. Additionally, the borrower may receive a loan on more favorable terms, or may be extended credit under circumstances where credit might otherwise not be extended at all. When using real estate as collateral, the most common method of securing the loan obligation is through the use of a mortgage. When using personal property as collateral, the most common method of securing the loan obligation is through a filing under Pennsylvania's Uniform Commercial Code, the effect of which is to make known to the public the lender's interest in the property. Because the laws relating to both creating a secured debt obligation such as a loan and the procedures available to enforce the securitization of the debt are complicated, advice from a professional is urged.