Unwrap Some "Gift Loan" Complexities of Section 7872

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Intra-family loans bearing below-market rates of interest can have gift tax consequences that are easily overlooked by clients.

The concept of intra-family gifts is well understood. If Art and Bob are brothers, and if Art transfers property to Bob for no consideration, then Art has made a gift to Bob. If the value of that gift (cumulative with all other gifts from Art to Bob in the same calendar year) exceeds the annual exclusion amount, then Art is required to report the gift on a federal gift tax return (Form 709). If instead of gifting property to Bob, Art makes a loan to Bob, Art has again made a gift unless the loan bears interest at or above the applicable federal rate (AFR).

What happens under Section 7872 if the loan does bear interest but at a rate below the AFR? A gift may be imputed, as is explained below.

HYPOTHETICAL SCENARIO

At the beginning of 2000, Art made two loans to Bob. The principal amount of each loan was $1 million, but one was a term loan and the other was a demand loan. The loans are structured as follows:

1. The term loan provided that at the end of 2005, Bob was to repay the amount borrowed with simple interest at 5%.
2. The demand loan called for repayment on demand, along with simple interest at 5%.

In the month the loans were made, assume the short-term AFR was 6% and the mid-term AFR was 7%. Under Section 7872(f)(2)(B), the AFR for a demand loan is the short-term AFR rate in effect for the period in which the amount of forgone interest is being determined, compounded semi-annually. Section 1274(d)(1)(A) specifies that the mid-term AFR applies for a loan with a term of longer than three years but not over nine years; thus, it applies to the five-year term loan.

After receiving the loans, Bob failed to pay any interest or principal on either of them. Art is much wealthier than Bob and never enforced his

rights under the term loan or made a demand under the demand loan. For many years, Art has also made cash gifts to Bob each year in the amount of the annual exclusion.

In 2015, Art met with his attorney to discuss preparation of a Form 709 for gifts Art made in 2014 to persons other than Bob. In the course of that meeting, Art disclosed the existence of the two promissory notes from 2000. Art has filed other federal gift tax returns after 2000 and prior to 2015, without reporting any gifts in connection with either of the two loans to his brother. What gift tax consequences arose in 2000 under Section 7872 given these facts?

TREATMENT OF BELOW-MARKET LOANS

Section 7872 applies to many different circumstances and has many exceptions. Section 7872 and all of the regulations, proposed regulations, and temporary regulations under Section 7872 fill more than 100 pages (as PDF files). For our fact pattern, we begin analyzing this question with Section 7872(a).

For any loan with a below-market rate of interest (1) where Section 7872 applies, and (2) which is a gift loan or a demand loan, Section 7872(a) specifies that the forgone interest is treated as having been transferred from the lender to the borrower and then retransferred from the borrower back to the lender, as interest. This seemingly straightforward language includes four defined terms and the caveat that the reader must look elsewhere to determine if the Code Section applies in the first place.

Below-Market Loan

A below-market loan is defined in Section 7872(e) as any loan where, for a demand loan, interest is payable at a rate less than the AFR, and for a term loan, the amount loaned exceeds the present value of all payments due under the loan.

Following the first example in Prop. Reg. 1.7872-14, the formula for determining the present value of a future payment should be as follows:

$$PV = FP / ((1 + (IR / NCPY))^{CP})$$

Where:

- PV is the present value.
- FP is the future payment whose present value is being determined.
- IR is the interest rate.
- NCPY is the number of compounding periods per year.
- CP is the compounding period.

So, the present value of $100,000 in three years at 5% interest compounded annually is $100,000 / ((1 + (.05 / 1))^3), which is $86,383.76. Likewise, if the compounding period was semi-annually (twice per year), the present value would be $100,000 / ((1 + (.05 / 2))^6), which is $86,229.69.

In calculating the present value of a loan that bears interest, the present value of both the principal to be repaid and the interest to be paid must be calculated separately using this formula, with the results added together for the total present value.

Gift Loan and Forgone Interest

A gift loan is a below-market loan where the forgoing of interest is in the nature of a gift.[1] Forgone interest is the excess of the interest that should have been charged and payable annually over the interest actually charged and allocable to the period in question.[2]

Demand or Term Loan

Finally, a demand loan is any loan payable in full upon demand of the lender, in contrast to a term loan, which is any loan that is not a demand loan.[3]

INADEQUATE INTEREST

Returning to the two loans at issue, consider the effect of Section 7872(a). The term loan bears interest at a rate lower than the AFR, all of the interest is due at maturity rather than payable annually, and as the amount loaned exceeds the present value of the payments due under the loan (see analysis below), it should be considered a below-market loan. The term loan is not payable in full upon demand of the lender and thus is not a demand loan, so Section 7872(a) would seem to apply only if it was a gift loan.

Based on Prop. Reg. 1.7872-4 and the context of the loan being between family members, from a wealthier family member to a less wealthy family member and made in the context of other gifts, it would appear that the term loan is a gift loan under Section 7872(f)(3). Likewise, the demand loan also bears interest at a rate lower than the AFR, and it is payable in full upon demand of the lender. Thus, it is a demand loan under Section 7872(f)(5). It too would seem to be subject to Section 7872(a). Having determined that the two loans should be subject to Section 7872, we must now determine when Section 7872 does and does not apply.

Applicable Loans

Under Section 7872(c)(1), Section 7872 applies to these categories of below-market loans:

- Gift loans.
- Certain compensation-related and corporation-shareholder loans.[4]
- Any below-market loan where one of the principal purposes is the avoidance of any federal tax.
- Other below-market loans, as described in the Regulations, if the interest arrangements have a significant effect on any federal tax liability of either the lender or the borrower.[5]
- Certain loans to qualified continuing care facilities.

Excepted Loans

Exceptions, of course, apply. Under Section 7872(c)(2), Section 7872 does not apply to gift loans made directly between individuals on any day when

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1 Section 7872(f)(3). Also, Prop. Reg. 1.7872-4(b)(1) provides that a below-market loan is a gift loan if the forgone interest is in the nature of a gift under Chapter 12.

2 See Section 7872(e)(2), Prop. Reg. 1.7872-6(c), and (with regard to demand loans) Prop. Reg. 1.7872-13.

3 Section 7872(f)(6). See also Prop. Reg. 1.7872-10(a).

4 Although addressing all of the rules of corporation-shareholder loans is beyond the scope of this article, for a discussion of Section 7872 in that context, see *KTA-Tator, Inc.*, 108 TC 100 (1997); *Rountree Cotton Co.*, 113 TC 422 (1999), *aff'd* 12 Fed. Appx. 641, 87 AFTR2d 2001-1454 (CA-10, 2001); *Estate of Hoffman*, 8 Fed. Appx. 262, 87 AFTR2d 2001-2119 (CA-4, 2001); and FSA 2434, 9/15/1998.

5 See Temp. Reg. 1.7872-5T and Prop. Reg. 1.7872-5.

the aggregate outstanding loan amount between the individuals does not exceed $10,000 and where the loan was not used to purchase income-producing assets.[6] The de minimis exception is conditioned on the general rule not having applied on any day, or said differently, if the general rule applies to a term loan on any day, the de minimis exception is no longer available under Section 7872(f)(10).

Additionally, under Section 7872(d), for loans that do not exceed $100,000 in the aggregate on any day, the income to be recognized by the lender will not exceed the borrower's net investment income, unless a principal purpose is the avoidance of any federal tax.[7] If the net investment income of a borrower for a year does not exceed $1,000, it will be treated as zero under Section 7872(d)(1)(E)(ii). One final twist under Section 7872(d)(2) is that, for any gift loan that is a term loan, Section 7872(b)(1), and not Section 7872(a), applies for purposes of Chapter 12 (gifts).

APPLYING THE RULES TO THE FACTS

As neither the term loan nor the demand loan appears to fit into the exceptions, they should follow the general rule in Section 7872(a), except as provided under Section 7872(d)(2) with regard to the term loan.

Term Loan

The term loan was for $1 million, while the present value of all payments due under the loan is $1,000,000 / ((1 + (.07 / 1))^5) (the principal) plus $250,000 / ((1 + (.07 / 1))^5) (the aggregate interest due under the term loan), which is $712,986.18 plus $178,246.54, for a total of $891,232.72.

This is less than the amount loaned, so the term loan is a below-market loan.[8] The forgone interest, which is in an intra-family context, should be considered to be a gift for purposes of Chapter 12, so the term loan also should be considered to be a gift loan. The term loan does not appear to fit the exceptions to the applicability of Section 7872, so as discussed above, we look next to Section 7872(b)(1).

Here, we see that Art is deemed to have transferred to Bob, on the date in the year when the loan was made, cash in an amount equal to the difference between the amount loaned, $1 million, and the present value of all payments due under the loan, $891,232.72–i.e., a gift of $108,767.28. Also, under Section 7872(b)(2), the term loan is treated as having original issue discount equal to the gift.

Demand Loan

Applying these rules to the demand loan, interest is payable at 5% annually but the applicable short-term AFR rate was 6%, so the demand loan is a below-market loan. Section 7872(a) applies to demand loans, and none of the exceptions to the applicability of § 7872 appear to apply. As a result, the forgone interest is deemed to have been transferred from Art to Bob as a gift and then paid by Bob to Art as interest.

The forgone interest is the excess of the interest that should have been paid, $60,000 per year, over the interest properly allocable to each year, $50,000, or $10,000 per year. So, in 2000, Art is deemed to have made a gift of $10,000 to Bob and Bob is deemed to have paid $10,000 of interest to Art. Also, as the $50,000 of interest required under the terms of the demand loan was not paid, it too should be considered to be a gift from Art to Bob, although not under Section 7872.

CONCLUSION

In total, under Section 7872 the term loan and the demand loan result in total gifts from Art to Bob, in 2000, of $118,767.28, as well as $10,000 of interest income to Art.

Having determined the gift tax consequences under Section 7872 of the 2000 gifts, other questions arise under the facts of the hypothetical scenario. How should the gifts in 2000 be reported? The 2000 gifts should have been reported on a timely filed federal gift tax return in 2001, but that reporting was not done in the scenario. Section 7872 takes into account all of the interest that should have been due during the term of the term loan, but in 2000 takes into account only the 2000 interest for the demand loan.

Looking past 2000, if the short-term AFR for any of 2001 through 2015 exceeded the 5% interest applicable to the demand loan, then there would be an additional gift in each such year where the short-term AFR in such year exceeded 5%. What happens after the term loan's maturity date passes? Does the term loan then become a demand loan at 5% which might subject it to further gift treatment under Section 7872, does it cease to bear interest, in which case again it would have further gift tax treatment, or should some or all of the principal be considered to be a gift because it was not paid and Art did not enforce his collection rights?

Additional questions arise based on the facts of the scenario which go further beyond the scope of this article. As stated above, Art filed gift tax returns reporting other gifts between 2000 and 2015. Does Art need to amend all filed gift tax returns from 2000 forward to report the 2000 gifts and any subsequent gifts arising from the term loan and the demand loan? Best practice would seem to require that this be done, and it would be consistent with how the gifts would have been reported if proper and timely reporting had been done.

Given how many years are at issue, it is tempting to consider whether Art could report all of the past gifts on a timely filed 2015 gift tax return, if an argument supporting that conclusion could be made. Remember that Art has already used all of his annual exclusions by making annual cash gifts

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to Bob from 2000 to 2015, so any gifts under Section 7872 during that period would need to be reported.

Additionally, as we are looking back in time, could it be argued that the passage of time, the lack of payments by Bob, and the lack of enforcement of Art's rights cause the unpaid or undemanded principal of each loan to be considered a gift, and if so, when? Possible time periods for a gift argument appear to include 2000, 2005 (maturity of the term loan), or the year in which the applicable statute of limitations rendered Art's rights unenforceable.

Conversely, could Art argue that Bob's failure to pay either the term loan or the demand loan allows him to treat one or both of these loans as bad debt? Perhaps, although as stated by the Fourth Circuit, "[c]hoosing not to enforce a debt does not render it worthless."[9] Finally, if Art had, between 2000 and 2015, used all of his then current applicable exclusion amount, then interest and penalties could apply to any tax that was not timely paid. Given the facts of the scenario, these issues would need to be addressed before the 2015 federal gift tax return could be prepared and filed.

Analyzing the gift consequences applicable under Section 7872 is complex, but determinable. The consequences of not following the requirements of Section 7872, however, can be much more difficult to determine.

NOTES

6 See also Prop. Reg. 1.7872-8. The $10,000 de minimis exception also applies to compensation-related and corporate-shareholder loans that do not have as a primary purpose the avoidance of any federal tax.

7 See Prop. Reg. 1.7872-4(e).

8 As the term loan in our example does not specify the period of compounding, we will assume annual compounding. Remember also that since all interest is payable at maturity, we are calculating the total amount of interest ($1,000,000 x .05 x 5) as a single payment in 2005. If interest was payable annually, then the present value of each separate payment of interest should be calculated separately.

9 *Estate of Hoffman*, *supra* note 4.