



June 7, 2010
Pennsylvania Personal Income Tax
No. PIT-10-002
Below-Market/Interest-Free Loans
Imputed Interest

ISSUE

What are the Personal Income Tax ramifications of a parent making a personal loan to a child interest free or below market rate?

CONCLUSION

There are no legal restrictions that would prohibit a parent from making an interest-free or below market rate loan to a child. However, Pennsylvania Personal Income Tax law requires interest from the loan to be imputed to the parent and reported as taxable interest income as explained below.

FACTS

Taxpayer made some personal loans to his child. Some loans were made interest free and some were at a five percent (5%) interest rate.

DISCUSSION

For Pennsylvania Personal Income Tax purposes, there are no legal restrictions that would prohibit a parent from making an interest-free or below market rate loan to a child. However, the fact that the loan is made interest free or below market rate does not mean that the parent is not required to report a minimum amount of taxable interest income from the loan for Pennsylvania Personal Income Tax purposes.

Under Pennsylvania Personal Income Tax law, "interest" is a taxable class of income. Interest income is defined as:

Interest derived from obligations which are not statutorily free from State or local taxation under any other act of the General Assembly of the Commonwealth of Pennsylvania or under the laws of the United States, any amount paid under contract of life insurance or endowment or annuity contract which is includable in gross income for Federal income tax purposes and any amount paid out of the Archer Medical Savings Account (Archer MSA) or health savings account that is includable in the gross income of an account beneficiary for Federal income tax purposes.

72 P.S. § 7303(a)(6).

Department regulations further define interest income, as follows:

(a) Generally. Interest includes any charge for the use or detention of money or for a forbearance from enforcement of a debt that is due, whether or not payable as such or as principal, including, for taxable years beginning on or after January 1, 1993, any excess of a publicly offered obligation's stated redemption price at maturity over the first price at which a substantial amount of the obligations included in the issue is sold to the public. For this purpose, the public does not include bond houses, brokers or other persons or organizations acting in the capacity of underwriters or wholesalers. As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest



income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, promissory note, mortgage or corporate bond or debenture; the interest portion of a condemnation award, usurious interest (unless by state law it is automatically converted to a payment on the principal); interest on legacies and life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of taxes.

(f) Unstated or imputed interest. Unstated or imputed interest for a taxable year beginning on or after January 1, 1993, including interest derived from government obligations, shall be computed in the same manner as it is required to be computed for Federal Income Tax purposes.

61 Pa. Code § 103.16.

As stated in Section 103.16(f) of the Department's regulations, "imputed interest for a taxable year . . . shall be computed in the same manner as it is required to be computed for Federal Income Tax purposes." The relevant Federal income tax law related to imputed interest is found at IRC § 7872 (treatment of loans with below-market interest rates).

In this case, Taxpayer made the loans to his child. For purposes of this ruling, it is assumed that the loan and Taxpayer's decision not to charge interest or below market-rate interest was done out of disinterested generosity. Therefore, the forgone interest on the loans was in the nature of a gift to the child. Consequently, for Federal income tax purposes, the loans are considered "gift loans." The Federal income tax treatment of the foregone interest on a gift loan is as follows:

(a) Treatment of gift loans and demand loans

(1) In general. For purposes of this title, in the case of any below-market loan to which this section applies and which is a gift loan or a demand loan, the forgone interest shall be treated as—

(A) transferred from the lender to the borrower, and

(B) retransferred by the borrower to the lender as interest.

(2) Time when transfers made. Except as otherwise provided in regulations prescribed by the Secretary, any forgone interest attributable to periods during any calendar year shall be treated as transferred (and retransferred) under paragraph (1) on the last day of such calendar year.

IRC § 7872(a).

For Federal income tax purposes, forgone interest is defined as follows:

The term "forgone interest" means, with respect to any period during which the loan is outstanding, the excess of—

(A) the amount of interest which would have been payable on the loan for the period if interest accrued on the loan at the applicable Federal rate and were payable annually on the day referred to in subsection (a)(2), over

(B) any interest payable on the loan properly allocable to such period.

IRC § 7827(e)(2) (emphasis added).

The applicable Federal rate is defined as:

(2) Applicable Federal rate

(A) Term loans. In the case of any term loan, the applicable Federal rate shall be the applicable Federal rate in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually.

(B) Demand loans. In the case of a demand loan, the applicable Federal rate shall be the Federal short-term rate in effect under section 1274(d) for the period for which the amount of forgone interest is



being determined, compounded semiannually.

The Secretary of the Treasury determines the applicable Federal rates monthly and publishes the rates on the Internal Revenue Service's website (www.irs.gov). The following is a link to the applicable rates on the IRS website: <http://www.irs.gov/app/picklist/list/federalRates.html>.

The Department of Revenue uses the above rules and applicable Federal rates to determine taxable imputed interest for Pennsylvania Personal Income Tax purposes.

A "gift loan" is a "below market loan where the foregoing of interest is in the nature of a gift." IRC. § 7372(f)(3).