
Your Weekly Tax Tip

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Phone: 318-868-1115

Understanding Tax Terms: AFRs



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Your grandson needs a car, but cannot afford the payments. As a favor, you provide the \$25,000 to purchase the car. You tell your grandson to pay you back when he can, but there is no loan document. The IRS sees this payment during an audit and asks you where your interest income is for this loan. Should this happen, you will quickly understand the meaning of AFRs.

AFRs Defined

AFRs stand for Applicable Federal Rates. They are minimum interest rates that the IRS applies to a transaction when no rate is stated or implied. In other words, you may have a transaction that the IRS believes has an interest

income/expense element to it, but none has been claimed by you. These minimum interest rates are published each month by the IRS for three different loan terms: Short-term (0 to 3 years); Mid-term (4 to 9 years); and Long-term (over 9 years).

When does the AFR apply?

You may think that money you gave to a friend or that car sale to your cousin with repayment over time has no interest rate, but the IRS often sees it differently. If no interest rate is stated, the IRS will apply the applicable AFR and you could be in for a tax surprise. Here are some common examples when the AFR rates can come into play:

- **Loans to family and friends.**
- **Buying anything over time.** If you take possession of an item, but can pay for it over a length of time, imputed interest is involved.
- **Employee advances.** This can include giving an employee the rights of stock ownership, but not expecting payment for the stock right away.

How to use the AFR knowledge to your advantage

1. **Create a loan document.** Whenever you establish a transaction that has the expectation of repayment, write up a simple loan agreement. Not only will it clarify your repayment expectation, it also establishes the repayment terms. Ensure both parties sign and date the document.
2. **Establish a safe interest rate.** Use the AFR tables to establish an audit-safe interest rate. Remember, AFRs are also used if the IRS believes your stated interest rate is too low.
3. **Leverage gift rules.** Remember you (and your spouse) can each gift up to \$15,000 to an individual. If you stay under this threshold, you could defend your money transfer as a non-interest bearing gift and not a loan.
4. **Caution with housing transactions.** Banks are asking buyers to document where they receive their money for their down payment. If the money comes from you, it could establish a potential implied loan document that you might need to defend. If you plan to help with a down payment in the future, try to understand the bank's look-back rules for this disclosure reporting and use this knowledge in conjunction with the IRS gift rules to avoid creating implied interest.

Should you wish to see the published AFR rates, they are available on the IRS website at www.irs.gov/AFRs.

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This Tax Tip was sent to BARBARA@CRAGERCPA.COM by

Crager LaBorde Certified Public Accountants, LLC

6105 LINE AVE STE 200
SHREVEPORT, LA 71106-2065
Phone: 318-868-1115
Fax 318-868-1119
www.cragercpa.com
barbara@cragercpa.com



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