

Loans Aren't Taxable Income, But What Exactly Is A Loan?

By Robert W. Wood

When your uncle or your best client loans you \$10,000 to tide you over, is it taxable income? Fortunately, no. What about when the bank loans you \$100,000? No again, provided it's a real loan.

In a personal, business or family context, loans aren't income. But the loan vs. income distinction tends to land lots of taxpayers in trouble. If you receive a payment you can't quite explain, you might be tempted to call it a loan.

When the facts are clear, so is the tax law. But when the facts are ambiguous about whether you have to pay back the money, thinking of it as a loan can seem expedient. After all, it may seem to be the perfect way of putting off the inevitable tax hit. However, be careful that such attempts at creativity don't stretch the truth.

Start with the knowledge that loans aren't income. Most loans are probably on commercial terms and with stated interest, so there shouldn't be any question in those cases. More informal loans may not call for interest but the Internal Revenue Service can impute interest.

When you pay your loans back they aren't deductible by you (except for the interest). As a corollary, the lender doesn't have income on the repayment, except for the interest the lender receives. But the fact that a payment is really a loan doesn't always mean there is no income *later*.

If a loan is forgiven, it suddenly *is* income. That's called cancellation of debt income, often shortened to *COD income*. You received cash when you borrowed the money, but when you don't have to repay it, that cash is no longer loan proceeds. Instead, it becomes current income.

The tax code generally taxes COD income, treating it like cash paid to you. This unpleasant rule might seem easy to ignore. However, when a loan is forgiven, you'll generally receive an IRS Form 1099-C from the lender reporting income to you — and telling the IRS.

If you receive such a form and disagree with the amount shown or the facts of the discharge, write the lender requesting a corrected Form 1099-C showing the proper amount of canceled debt. But whatever you do, don't ignore Forms 1099. The IRS receives a copy and will assume you have income, which it will expect to match up on your tax return.

In some cases COD income isn't taxed. For example, COD income is not taxed if the discharge is part of a bankruptcy case. Even outside of bankruptcy, it isn't income if you are insolvent. If you believe the canceled debt isn't income to you because you're insolvent or for any other reason, you'll need to address this on your return.

If you receive loan proceeds, can the IRS come along and claim that a "loan" you received — that is still outstanding and hasn't been forgiven — isn't a loan at all and was actually income? Yes, it can.

This unsettling issue often arises in the context of families. If a family member sends you money it must either be a loan, income or a gift. Which it is varies with the facts and how the parties report and handle it. In a more commercial setting, the choices may be income or loan.

In some cases, the question will be whether a payment is "loan" proceeds or sales proceeds and therefore taxable. That's exactly what happened in *Jonathan S. Landow v. Commissioner*, T.C. Memo. 2011-177 (2011). Landow took out a 90 percent loan against securities he put up as collateral. At least it sure looked like a loan.

However, this loan was nonrecourse. That meant that Landow could not be sued personally if he defaulted. Yet, the securities were pledged as collateral.

At this point, it still looked like a loan. As it turns out, though, the lender had the ability to sell off the securities in ways that were unusual for garden-variety loans. And that's just what the lender did, despite the fact that Landow later claimed he had no idea his securities would be sold.

Nonetheless, Landow failed to pay back *any* of the \$13.5 million principal amount of the loan. He also didn't report the "loan proceeds" as income. When the IRS discovered this, it claimed that this whole "loan" transaction really wasn't a loan at all.

From the beginning, the IRS claimed, this was a sale. The Tax Court agreed with the IRS, treating this loan deal as a highly orchestrated transaction. Everyone *knew* the transaction would be documented as a loan, but it *really* amounted to a sale.

How real is the danger that the IRS will treat loans as sales? In transactions like Landow's, very real. Landow's deal was part of a litigated and controversial tax shelter that has produced a series of cases. See *Shao v. Commissioner*, T.C. Memo. 2010-189 (2010), and *Kurata v. Commissioner*, T.C. Memo. 2011-64 (2011). In that sense, the result in Landow's case was no surprise.

More generally, though, how you structure the transaction is important. So is how the transaction actually plays out and how the parties report each side of their transaction. In general, courts look to indicators such as whether legal title passes, how the parties treat the transaction and the parties' intent.

There can be danger in simple family transactions too. There, the question is often whether something is a loan or a gift. Gifts may not trigger income tax, but they can trigger gift tax.

Are you facing characterization questions? Is it possible to see a payment as a loan, as income or as a gift? Whether the issue arises in a family or business context, be careful and be realistic.

Think about taxes up front and about what you intend. Document the transaction in a way that is appropriate and that you can support. Trust me, everyone will be better off.



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