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CERTIFIED PUBLIC ACCOUNTANTS

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Dear Client

We are writing in response to your inquiry concerning below market loans. This letter will briefly summarize the various types of transactions that the IRS characterizes as being below market-rate loans, and the consequences to the borrower and lender in light of such a determination. Once you have had a chance to review the material in this letter, We suggest that we get together in order to discuss your particular situation.

The below market loan (BML) rules apply only to those types of loans specified in the Internal Revenue Code and accompanying regulations. They are as follow: gift loans, compensation related loans (loans from employers to employees), loans from corporations to shareholders, tax avoidance loans, loans with a significant tax effect, and loans to continuing care facilities. In general, an interest-free or below market loan, together with any other loan used to avoid tax, will be recharacterized as an arm's length transaction whereby the lender will be considered to have made a loan to the borrower in exchange for a note at the applicable federal interest rate (AFR). The lender is then considered to have made a gift (subject to the gift tax rules) to the borrower of the forgone interest, paid a dividend or made a contribution to capital (in the case of a corporation or shareholder loan), paid compensation (in the case of a compensation related loan), or made some other payment characterized in accordance with the transaction.

Please be advised that a loan is defined in the proposed regulations as a transaction in which one person allows another to use his or her money for a period of time after which it is to be returned to the owner. Additionally, the regulations set out situations that are specifically included or excluded from being characterized as a loan. Also, please note that the BML rules for demand loans differ from term loans. Once it has been determined that a loan is a BML, both the lender and the borrower have to determine the tax consequences because, in addition to having to report them on their own returns, they have to file information returns reporting the transactions.

Where the interest arrangements on loans have no significant effect on the federal tax liability of either the lender or the borrower, such loans are generally exempt from the BML rules. The IRS has promulgated regulations exempting 13 classes of transactions from the BML rules. In addition, there are certain regulatory exemptions for: employee relocation loans, loans to continuing care facilities, loans to employees conditioned on the performance of future services, and loans from foreign lenders to U.S. borrowers. Finally, there is a de minimis exception for certain gift loans and for compensation-related corporation-shareholder loans.



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The BML rules are complex and require informed judgment before entering into a transaction. Additionally, the rules for computing forgone interest are particularly complex. For this reason, the facts of your situation should be carefully reviewed. We suggest that you contact us to arrange a meeting in which we can further discuss the tax consequences of your proposed transaction.

Sincerely,

George K Hashem

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