Chapter 5

The Promissory Note

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A promissory note is a formal contract between parties. It is a written, signed, unconditional promise to pay a certain amount of money on demand or at a specified time or over a period of time. A promissory note is used to memorialize a promise to pay a sum of money by a future date in exchange for a loan or various financing at present. The individual who promises to pay is the **maker**, and the person to whom payment is promised is called the **payee** or **holder**. For example, if two people enter into a promissory note, the maker and holder each have legal obligations to perform certain duties under the contract. Typically, the maker will borrow money from the holder, and will have a payment schedule detailed within a promissory note to return the lent money to the holder at a later date. 

A promissory note can be either secured or unsecured. A secured promissory note is one that specifies collateral securing the amount loaned to the note maker (the borrower). This means that the holder (lender) protects his interest in the borrowed money by loaning money to the maker against the maker’s collateral. For example, if the maker (borrower) owns a piece of property, the holder (lender) can loan the maker money and, in addition to the promissory note, require the maker (borrower) to grant the holder (lender) an interest in the property until the promissory note is satisfied (i.e., the maker fully paid his debt with the holder). If the maker fails to pay according to the terms of the promissory note, the holder can foreclose on the property that secured the note, thereby recovering the unpaid principal of the note, interest, fees and expenses.

An unsecured promissory note is one that is not secured by any collateral. With this type of promissory note, the maker borrows money from the holder without relinquishing any interest in his property. The holder’s recourse in the event of non-payment will be through the debt collection process.

A promissory note may contain other terms such as the right of the holder to order payment be made to another person, penalties for late payments, a provision for attorney’s fees and costs if there is a legal action to collect, the right to collect payment in full if the note is secured by real property and the property is sold (“due on sale” clause), and whether the note is secured by a mortgage or deed of trust or a financing statement (a filed security agreement for personal collateral).

To avoid potential liability, it is important to consider whether the loan transaction falls within federal or state securities regulations (see Chapters 1 and 2, Federal and State Securities Regulations). Whether a promissory note is a security is a complicated legal question. The answer will involve an assessment of the investment scheme of which the promissory note is a part. When seeking investments or loans in the form of promissory notes, businesses should consult legal counsel to be sure that their plan either would not be considered a security or whether an appropriate exemption from federal or state rules would apply.

Generally, promissory notes are presumed to be securities, especially when they are not secured with collateral. Remember, the general intent of securities regulation is to provide anti-fraud protections for members of the public contributing capital.

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33 Title 9A Article 3 of the Vermont Code Annotated.
Courts may be more likely to view a holder of a note without collateral more vulnerable to fraud than a holder of a note with collateral. The conservative view is that a promissory note with a maturity of more than nine months is a security. Promissory notes, while not relevant to all types of “community financing” as defined in this guide, are considered indispensable in many community financing agreements because they provide ample room for creativity in setting the repayment terms of the loan. Repayment schedule, interest payments, the nature of these payments and other variables can be based on the needs of the community—represented by the holder and maker of the note who are both members of the community. As long as the core elements of the legal contract are in place (see Appendix 3: Contract Basics), other clearly articulated terms within the promissory note should be legally legitimate. When in doubt, consult with a licensed attorney who can review the final draft of the contract. The way in which principal and interest payments are set will also have tax implications, so a certified accountant should also be consulted to better understand these effects.

Two sample promissory notes are provided in Appendix 4 of this guide.

### What about a Zero Interest Loan?

In the eyes of the IRS, “zero-interest loan” is an oxymoron. The U.S. Tax Code (section 7872) sets requirements for how loans with below-market interest rates are treated for tax purposes. An interest rate is generally “below-market” if it is below the “Applicable Federal Rate” (AFR), set monthly and made publicly available online or at IRS offices. The general rule is that interest will be “imputed” or implied by the IRS, when it is not stated by a lender and borrower in their loan contract, or it is stated by the loan agreement to be less than the AFR.

A “gift loan” is the closest thing to a zero-interest loan that the IRS recognizes. According to Section 7872, the term, “gift loan” means any below-market loan where the forgone of interest is in the nature of a gift. A gift loan, as in other types of below-market loans, involves imputed interest. The consequence for the lender is he/she can be taxed even when there is no interest income that was received! The borrower might be able to deduct the implied interest payment even if there was no real payment made! These rules are complicated and might not make sense. This is all the more reason to seek the assistance of a Certified Public Accountant or other tax adviser.

There are exceptions within the below-market loan rules to the requirement to impute interest. There is the $10,000 exception and the $100,000 exception, both applicable to loans made directly between individuals. For loans totaling less than $10,000 in value, the loan meets the exception if the proceeds are not used to purchase income-producing assets. This would disqualify most farmers crafting community financing agreements to provide start-up or operating capital for farm operations. The second exception, the $100,000 exception, does not contain disqualifiers about income-producing assets, and thus would likely be relevant to farms. As long as the loan amount is less than $100,000, and the borrower’s annual investment income (interest and dividends reported on his/her tax returns) is below $1,000, then interest is not required to be imputed in the deal. If the borrower’s investment income is greater than $1,000 then the amount of imputed interest is capped at the amount of the borrower’s investment income.

Again, these rules might not make sense to the average person who is not familiar with the U.S. tax code. The above is only an introduction to the IRS below-market loan rules. For these reasons, when crafting debt instruments that integrate “patient” or creative financing terms, it is highly advisable to enlist the assistance of a qualified tax attorney and/or a Certified Public Accountant or other tax adviser.

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34 However, some courts have used the “family resemblance test” (See Reves, 494 U.S. 56, at 67 (1990)) to scrutinize whether a promissory note is a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security. A note with a term of more than nine months is presumed to be a security.