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Balance sheet

Tax-smart Personal Loans to Family Members or Friends

By Richard D. Hillabrand, CPA

There may be times when a family member or friend asks for a loan. Perhaps a child needs a down payment for a first home, or a friend cannot pay his or her tax bill. Wanting to help is commendable; however, if you follow through, please make it a tax-smart loan. This letter explains how to avoid unexpected (and generally adverse) tax consequences when you make a personal loan to a relative or friend.

Many loans made to family members or friends are below-market loans. By that, we mean loans that charge either no interest or a rate below the Applicable Federal Rate (AFR). The AFR is the minimum interest rate you can charge without creating unwanted tax side effects. Right now, AFRs are still low by historical standards, so making a loan that charges the AFR instead of a lower (or 0%) rate makes a lot of sense. Why? You can give the borrower a good deal on the interest rate without causing any tax complications for yourself.

For term loans (those with specified repayment dates), the relevant AFR is the rate in effect for loans of that duration for the month the loan is made. For example, you make a term loan to a relative or friend in April of this year. For a short-term loan (one with a term of three years or less), the AFR is 2.49% (assuming monthly compounding). The AFR for a mid-term loan (over three years but not more than nine years) is a very reasonable 2.52%. the AFR for a long-term loan (over nine years) is 2.85%. The same AFR continues to apply over the life of the loan, regardless of how interest rates may fluctuate during that time.

As you can see, the quoted AFRs are lower than the rates charged by commercial lenders. As long as you charge at least the AFR on a loan to a family member or friend, you do not have to worry about any of the income and gift tax complications.

Regardless of the interest rate you plan to charge, which will be reported as interest income on your income tax return, you will want to be able to prove you intended the transaction to be a loan rather than an outright gift. That way, if the loan goes bad (which happens frequently with family members), you can claim a nonbusiness bad debt deduction on your tax return.

Losses from nonbusiness bad debts are considered short-term capital gains (losses); you can deduct up to $3,000 of the excess loss against your income from other sources (salary, self-employment income, interest, dividends, and so on) or up to $1,500 if you use married filing separate status. Any remaining loss gets carried forward to next year and will be subject to the same rules.

Without a written document, your intended loan will probably be re-characterized as a gift by the IRS if you get audited. Then, if the loan goes bad, you will not be able to claim a nonbusiness bad debt deduction. Also, if your intended loan is over $15,000 and is re-characterized as a gift, you will either owe federal gift tax (unlikely) or burn up part of your unified federal gift and estate tax exemption (more likely). The latter could result in higher gift or estate taxes down the road.

To avoid these problems, your loan should be evidenced by a written promissory note that includes (1) the date the loan was made and the due date; (2) the interest rate, if any; (3) a schedule showing dates and amounts for interest and principal payments; and (4) the security or collateral for the loan, if any. Also, make sure the borrower signs the note. If your relative or friend will be using the loan proceeds to buy a house and you are charging interest, be sure to have the note legally secured by the residence. Otherwise, the borrower cannot deduct the interest as qualified residence interest.

If you have any questions about these details, please contact us; we can help.

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