ARRANGING TAX-SMART LOANS TO FAMILY MEMBERS

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In these still-tough economic times, you may want to help a financially challenged relative or friend by loaning that person some money. That's a commendable deed. However, please make it a tax-smart loan. This alert explains the up-front planning needed to avoid unexpected, and generally adverse, tax consequences when you loan money to a relative or friend.

YOUR LOAN'S INTEREST RATE AND THE APR

In many cases, loans between family members or friends are below-market loans. By that we mean they charge either no interest or a rate below the applicable federal rate, or AFR. The AFR is very important because it's the minimum rate you can charge without creating unwanted tax side effects 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. Right now even with the Fed moving up rates, AFRs are still reasonably low, so making a loan that charges the AFR rate can still make sense. That's because you can give the borrower a good deal on the interest rate without causing any tax complications for yourself.

Here's what we mean. Say you made a term loan to a favorite relative in November 2022. For a short-term loan (one with a term of three years or less), the AFR is 4.46% (assuming monthly compounding). The AFR for a midterm loan (over three years but not more than nine years) is 4.19%. The AFR for a long-term loan (over nine years) is 4.25% as of November 2022.

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. However, as long as you charge at least the AFR on a loan to a family member or friend, you don't have to worry about any of the income tax and gift tax complications that we will spend much of the rest of this letter explaining.

BE SURE TO GET YOUR LOAN IN WRITING

Regardless of the interest rate you intend to charge, you'll 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, you can claim a nonbusiness bad debt deduction on your tax return.

Losses from nonbusiness bad debts are considered short-term capital losses. They are valuable because they can offset capital gains. If your nonbusiness bad debt loss exceeds your capital gains for the year, you can deduct up to $3,000 of the excess against your income from all other sources (salary, self-employment income, interest, dividends, and so on). Any remaining loss gets carried forward to next year and will be subject to the same rules next year.

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Without a written document, your intended loan will probably be recharacterized as a gift by the IRS if you get audited. Then if the loan goes bad, you won't be able to claim any nonbusiness bad debt loss deduction. Also if your intended loan is over $16,000 ($17,000 in 2023) and is recharacterized as a gift, you'll 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 interest rate, if any; (2) a schedule showing dates and amounts for all interest and principal payments; and (3) security or collateral for the loan, if any.

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 can't deduct the interest as qualified residence interest.

At the time you make the loan, it's also a good idea to write a memo to your tax file documenting reasons why it seemed reasonable to think you would be repaid. Again, this supports your contention that the transaction was always intended to be a loan rather than an outright gift. Finally, if you keep written financial records—such as a personal balance sheet—be sure you show a loan receivable on the asset side of your ledger. Then, do the necessary bookkeeping to track interest and principal payments and reductions in the loan balance. If you have questions about these details, we can help.

TAX RULES FOR BELOW-MARKET LOANS

As we just explained, the tax results are very straightforward if your loan will charge an interest rate that equals or exceeds the AFR. If you insist on charging less or nothing, you'll have to finesse the tax rules to avoid unpleasant surprises. Here's what you need to know.

When you make a below-market loan (one that charges an interest rate below the AFR) to a relative or friend, the Tax Code treats you as making an imputed gift to the borrower. The imaginary gift equals the difference between the AFR interest you "should have" charged and the interest you actually charged, if any. The borrower is then deemed to pay these phantom dollars back to you as imputed interest. Although this is all fictional, you must still report the imputed interest as taxable income on your Form 1040. The resulting tax hit is not fictional. When your imputed gift to the borrower exceeds $16,000 for the year in 2022, it can also have adverse gift and estate tax consequences.

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The tax code provides a couple of notable exceptions to the imputed interest rules:

- Gift loans of less than $10,000 are exempt, as long as the money isn't used to buy income-producing assets.
- In the case of gift loans between individuals where the total amount outstanding does not exceed $100,000, the amount deemed transferred from the borrower to the lender at the end of the year will be imputed to the lender only to the extent of the borrower's annual net investment income. If such income is less than $1,000, no imputed interest is deemed transferred to the lender. An example might help here:. Assume Michael makes an interest-free $90,000 loan to his daughter, Rachel, so she can start a business. He forgoes $5,000 interest each year so that the Internal Revenue Service will the loan as a $5,000 gift. There is no gift tax, since it is less than the annual gift tax exclusion amount, and Michael owes no tax on the forgone interest if Rachel has $1,000 or less of net investment income. However, if Rachel's net investment income is $3,000, for example, then $3,000 should be included as income to Michael bas the lender.
- Certain below-market loans by individuals to qualifying continuing care facilities, made pursuant to a continuing care contract, are also exempt from the imputed interest rules. Generally, this exception applies if the lender (or lender's spouse) attains age 62 before the close of the calendar year.

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