Making a Loan to a Family Member

When asked if they would make a loan to a family member, most people will immediately respond, “No way!”. After all, loans to family members almost always lead to ruined relationships, strained finances and maybe even trouble with the IRS. If, however, your family is like most families, it is inevitable that you will be hit up for a loan by a relative sooner or later. If you are asked nicely enough, chances are you will even say “yes”.

Many loans to relatives are made on the basis of a handshake, but they should be handled in writing and in a businesslike manner. If not, the IRS could get involved and a simple loan to your sister could turn into a major headache. Potential IRS issues involved with loaning money to a relative include imputed interest and gift tax consequences.

Interest-free loans or loans charging less than the market rate are the norm when relatives are involved. While the lender relative may believe he is doing a favor for the borrower, such an interest-free loan will not be viewed as such by the IRS. On interest-free loans to relatives or loans charging less than the market rate, the IRS generally will impute interest to the lender and will tax the lender on such interest. Thus, the lender will be taxed on interest he did not actually receive. The interest imputed by the IRS will equal the applicable federal rate (“AFR”) for the month in which the loan is made. The AFR is determined by the length of the loan: the loan is considered either short-term, mid-term or long-term. The IRS publishes AFRs monthly in the Internal Revenue Bulletin, and the AFR for the month of January 2009 for a long-term loan (over 9 years), for example, was 3.57%.

There are two (2) exceptions to this imputed interest rule. The first exception is the $10,000 exception. The imputed interest rules do not apply to a below-market loan of $10,000 or less, and to loans for which the proceeds are not directly used to buy income-producing assets such as stocks, bonds and notes. Thus, a family member may make a loan to another family member for $10,000 or less and not charge interest as long as the proceeds of the loan are not used to purchase stocks, bonds, notes or other income-producing assets.

The second exception to the imputed interest rule is that the imputed interest will be zero when the aggregate balance of all outstanding loans (interest-free or otherwise) between the borrower relative and lender relative is $100,000 or less, and the borrower’s net investment income for the year is no more than $1,000. Thus, if the total of all outstanding loans between borrower and lender is less than $100,000, AND the borrower’s net investment income for the year is less than $1,000, then the lender will not be taxed on imputed interest. To qualify for the $100,000 rule, the lender must have an annual statement that discloses the borrower’s net investment income.

There are also gift tax consequences that lenders should be aware of. When a lender makes a below-market loan to a relative, the IRS treats the lender as making an “imputed gift” to the borrower. The gift tax consequences will depend on whether the

loan agreement between the borrower and lender is a "demand note" or a "term note". If the note is designated as a "demand loan", then the lender can legally demand full repayment of the loan at any time. With a demand loan, the imputed gift amount is calculated on a yearly basis and is equal to the imputed interest for that year. The annual limit on tax-free gifts in 2009 is $13,000, and if the imputed gift amount is less than the annual limit, then there will be no gift tax consequences. On the other hand, if the loan is a "term loan" or a loan calling for installment payments, the IRS will add up all the interest which will be paid for the life of the loan and count it as a gift in the year the loan is made. The result could be a relatively large imputed gift that exceeds the $13,000 annual tax-free limit.

These below-market rules concerning loans to relatives can be a little confusing and tricky, and you should make sure you understand them before you enter into a loan agreement with a related party. If you do not, you run the risk of dealing with both the IRS and an angry relative!

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