FirstPoint Financial

Providing Loans to Family Members

George's son, Kevin, lost his job last year and is now having trouble paying his mortgage. George is happy to help his son by lending him six months' worth of mortgage payments. However, George may not be so pleased if his intra-family loan triggers a gift and income tax liability.

Because of recent difficult economic times, this fictitious scenario – or one similar – is likely playing out in many households. If yours is among them, it's important to understand how the IRS defined an intra-family loan and the rules surrounding such a loan.

A bona fide loan or a gift?

When lending money to family members, ask yourself, "Is this transaction truly a loan?" If the IRS concludes that the transaction isn't a bona fide loan, it will re-characterize it as a taxable gift. By formalizing the transaction and treating it as a loan, you can avoid negative tax consequences and have the necessary documentation to support a bad-debt deduction in the event the borrower defaults.

The IRS and courts look at several factors in determining whether a transaction is a loan or a gift. Although no one factor is controlling, an intra-family loan is more likely to be viewed as bona fide if there's a written agreement, interest is charged and there's a fixed repayment schedule. In addition, the borrower must execute a promissory note and actually make the payments.

Not all of these factors must be present, but the more that are, the better the chance of the loan withstanding IRS scrutiny. Regardless of how much you plan, no strategy is bulletproof. The IRS can re-characterize a loan as a gift if it determines that the loan's purpose was to avoid taxes.

Is adequate interest being charged?

If an intra-family transfer is a loan, the next question to consider is, "Are you charging adequate interest?" A loan is considered below market if you charge less than a minimum interest rate, which is determined by the applicable federal rate (AFR). The federal government periodically sets the AFR, and the rate varies depending on the type and term of the loan.

For example, the minimum rate for a demand loan (one that's payable on demand or has an indefinite maturity) is the short-term AFR, compounded semiannually. So, the minimum rate varies during the life of the loan. The easiest way to ensure that you charge enough interest for a demand loan is to use a variable rate that's tied to the AFR. For a loan with a set term, use the AFR that's in effect on the loan date.

Type of loan affects tax impact

Below-market loans to family members have both income and gift tax consequences that differ depending on the loan type. For a demand loan, each tax year you're treated as if 1) you'd made a taxable gift equal to the amount of imputed interest, and 2) the borrower transferred the money back to you as an interest payment.

Imputed interest is the difference between the AFR and the amount of interest you actually collect, recalculated annually. Depending on the loan's purpose, the borrower may be able to deduct this interest.

If interest is imputed to you, you'll owe income taxes on the fictitious payments. In addition, you may have to pay gift taxes if the imputed interest exceeds the $13,000 annual gift tax exclusion. There are two important exceptions that allow you to avoid the imputed interest rules — or at least lessen their impact. First, loans up to $10,000 are generally exempt. Second, loans up to $100,000 are exempt if the borrower's net investment income for the year is $1,000 or less. If net investment income exceeds $1,000, the imputed interest rules apply, but the amount of interest is limited to the amount of net investment income.

Term loans are treated essentially the same way as demand loans for income tax purposes. But the gift tax consequences are quite different. If you make a below-market term loan to a family member, your gift is equal to the excess of the loan amount over the present value of all future loan payments (using the AFR as the discount rate).

If you choose to make a low-interest or no-interest loan to a family member, try to avoid a term loan so you don't make a substantial upfront gift.

A positive outcome

Whatever your reason for lending money to a family member, be sure you understand IRS rules governing intra-family loans. Working with your CPA or tax attorney to ensure that your loan won't incur income and gift tax liabilities will help result in a positive outcome for you and your loved one.

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