How to Set Up an IRS-Approved Family Loan

Today's relatively low-interest-rate environment makes it easy to loan money to family members on favorable terms with full IRS approval. Here's a rundown of what the law covers and why now might be a good time to set up loans.

Nothing in the tax law prevents you from making loans to family members (or unrelated people for that matter). However, unless you charge what the IRS considers an "adequate" interest rate, the so-called *below-market loan* rules come into play.

For instance, let's say you loan $50,000 interest-free to your daughter so she can buy her first home. Under the below-market loan rules, this can have unexpected income tax consequences for both you and your daughter, as well as gift tax consequences for you. Who needs the hassle?

The alternative is to charge an interest rate equal to the "applicable federal rate" (AFR). As long as you do that, the IRS is satisfied and you don't have to worry about any tricky tax rules biting you. As the lender, you simply report as taxable income the interest you receive. On the other side of the deal, the borrower may be able to deduct the interest expense on his or her personal return, depending on how the loan proceeds are used.

Even better, interest rates these days are reasonable. The AFRs for February 2019:

Documentation is important with family loans. If the person never pays you back, and you make a good faith attempt to collect, you'll want to claim a non-business bad debt deduction. These write-offs are treated as short-term capital losses.

If you don't document your loan and you're audited, the IRS may say the family loan was a gift and disallow a bad debt deduction. And there could be problems because you didn't file a gift tax return.

- 2.54% for "short-term" loans of three years or less.
- 2.60% for "mid-term" loans of more than three years but no more than nine years.
- 2.87% for "long-term" loans more than nine years.

AFRs are updated each month in response to ever-changing bond market conditions. So rates may not stay this low indefinitely.

For example, if you decide to lend $50,000 to your daughter, you could charge the mid-term AFR (2.60% in February of 2019) for a 108-month loan (nine years). She can pay that same low rate for the entire loan term with the government's blessing. Say you want to make it a 15-year loan instead. No problem. Just charge a rate equal to the long-term AFR (2.87% in February of 2019). Your daughter can pay that same low rate for the entire 15-year loan term.

However, these rules apply to *term* loans. When you make a *demand* loan, which can be called in anytime, the AFR isn't fixed in the month you make the deal. Instead, you must charge a floating AFR, based on fluctuating short-term AFRs. So if you believe rates are headed higher in the future, it's best to set up a term loan (one with a specific repayment date or specific installment repayment dates). That locks in today's AFR for the entire duration of the loan.

With this plan, everybody should be happy. You'll be charging an interest rate the IRS considers adequate. The borrower is likely to be pleased with the low rate. And you're glad to give the borrower some financial assistance without creating any tax complications.

Another plus: Under a favorable tax law loophole, you're completely exempt from the below-market loan rules if the sum total of all loans between you and the borrower adds up to $10,000 or less. (This includes all outstanding loans to that person, whether you charge adequate interest or not.) Thanks to this loophole, interest-free loans of $10,000 or less generally don't cause any tax difficulties for either you or the borrower.

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