



LENDING TO A BUSINESS, RELATIVES AND FRIENDS

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When lending money, the IRS (and common sense) requires that you follow a few rules. One such rule demands that you charge what the IRS deems to be an adequate interest rate on loans totaling at least \$10,000. Failing to charge such an interest rate can trigger “below market loan” rules which may result in gift tax consequences for you and income tax consequences for both you and the borrower.

This problem is easily avoided by charging an interest rate equal to the “applicable federal rate” (AFR) that is published by the IRS on a monthly basis. As the lender you would report the interest that you receive as taxable income, and the borrower may be able to deduct the interest paid as an expense.

The AFRs today are nominal:

- 0.19% for short term instruments having a term of 3 years or less.
- 1.12% for mid term instruments having a term between 3 and 9 years.
- 2.55% for long term instruments having a term in excess of 9 years.

A long term loan made today would have an interest rate of 2.55% for the duration of the loan (even though AFRs are updated monthly). However, the interest rate on demand loans, which can be called at anytime, would vary with the fluctuation in the monthly AFR.

How a loan is documented could be the subject of several future posts (you can find forms of simple promissory notes [here](#) and [here](#)), but I’ll emphasize that all loans should be in writing. For example, a lender may be able to claim a bad debt deduction (which is favorably treated as a short term capital loss) if the borrower is unable to repay a documented loan. On the other hand, if the lender is subject to an IRS audit, an unpaid loan that is not documented may be treated as a gift without the favorable tax benefit (and a penalty imposed for not filing a gift tax return).

What has your experience been with lending money, or borrowing from a friend or relative -- share your thoughts in the comments below [Jerry FT Blog](#) or email me at jcohen@ctswlaw.com.

Y. Jerry Cohen, Partner
(212) 586-5800