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Minimum Interest Rates on Loans to Relatives and Friends

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There can be income tax and/or gift tax consequences if an individual loans money to a relative or friend at a below market rate (BMR) of interest. An interest rate is BMR if it is less than the appropriate federal rates (AFR). The BMR provisions basically require a lender and a borrower to recognize a minimum amount of interest income and expense, if the interest rate provided in the loan agreement is less than the AFR. The minimum amount is the interest calculated at the appropriate AFR.

Applicable Federal rates are published on a monthly basis – providing applicable rates for short, mid, and long-term loans. Additionally, AFR (also known as safe harbor rates) are provided for monthly, quarterly, semi-annual, and annual compounding. The AFR for June 2001 are as follows:

	Annual	Semi-annual	Quarterly	Monthly
Short-term	4.15%	4.11%	4.09%	4.08%
Mid-term	5.02%	4.96%	4.93%	4.91%
Long-term	5.75%	5.67%	5.63%	5.60%

The short-term AFR is for loans with terms of 3 years or less. The mid-term is for loans with terms over 3 years, but not over 9 years. The long-term AFR is for loans with terms of over 9 years.

IRS Code provides some exceptions to the BMR provisions. For loans to family and friends the following two exceptions can provide relief from compliance.

1. **Loans of $10,000 or less.** The BMR provisions do not apply when the total outstanding amount of loans between the borrower and lender is $10,000 or less and the loan funds were not directly used to buy or carry income producing assets.
2. **Limit on forgone interest for gift loans of $100,000 or less.** If the outstanding loans between the lender and borrower total $100,000 or less, the forgone interest to be included in income by the lender and deducted by the borrower is limited to the amount of the borrower's net investment income for the year. If the borrower's net investment income is $1,000 or less, it is treated as zero. A gift loan is any BMR loan where the forgone interest is in the nature of a gift. This exception is applicable only to income tax. Gift tax consequences are not eliminated.

For gift and demand loans, the difference between the interest calculated using the stated rate and the AFR is generally treated as income to the lender and a gift from the lender to the borrower on December 31.

For term loans, a lender who makes a BMR loan is treated as transferring (gifting) the difference between the amount of the loan and the present value of all the scheduled payments, using the AFR, to the borrower on the date the loan is made. A term loan is defined as any loan that is not a demand loan.

Note of caution: these two exceptions do not apply to any loan if the avoidance of federal tax is one of the main purposes of the interest rate arrangement.

The IRS publishes the applicable federal rates each month in the *Internal Revenue Bulletin*. The *Internal Revenue Bulletins* are available on the web at http://www.irs.gov/ind_info/bullet.html. Additionally, your accountant and/or tax consultant should have resources that publish the applicable federal rates.
