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The Blair Family

business sen$e

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Loans Between LOVED ONES

Loaning money to family and friends is a tricky business for many reasons. Taxes are among them. Funds received as proceeds of a loan aren't taxable if the borrower is expected to pay it back.

However, the moment some or all of the debt is forgiven (doesn't need to be paid back), the IRS will want its cut. This is true for loans from banks and other business entities — including foreclosures, repossessions, voluntary transfers of property to lenders, property abandonment, and mortgage modifications — as well as good-faith loans between family and friends.

Don't be caught off-guard by unexpected income taxes when this happens. Instead, keep the following tips in mind, both as a potential lender or a borrower.

Pay attention to your mail

An indication of a canceled debt larger than $600 would be the arrival of Form 1099-C. Any institution or creditor that forgives a debt of that size is required to submit the form to both the borrower and the IRS. If the borrower disagrees with what the form states, it's essential to work with the lender to correct it before tax time.

Also, keep in mind that entities may send the form to the IRS but overlook sending the borrower a copy. Just because a borrower didn't receive notification doesn't mean the IRS wasn't informed.

Structure the loan carefully

Sometimes the IRS won't wait for the cancellation of debt (COD) to determine a loan is taxable. This can happen when a loan more closely resembles a tax-sheltered sale or gift. A sale, for instance, can easily be triggered when property passes between interrelated businesses. A sale is also triggered when the property is seized to help satisfy a debt.

When it comes to gifts, the IRS is quick to scrutinize family "loans" that are loosely structured. For family loans to pass the tax-free test, they should be well documented with a promissory note and a fixed repayment schedule that includes interest and/or principal and no pre-arranged schedule for forgiveness (or pay-back-when-you-can). They should also be valued at the market rate, which means the rate should be set at or above the Applicable Federal Rate (AFR) that was in effect when the loan originated.

Consider your options

Loans between family members are a great tool to help loved ones get ahead. Don't be afraid to consider them, but also be smart about them. It's important to work with a tax professional to ensure any nontraditional loans you consider are 1) necessary and 2) structured appropriately to avoid excessive taxes. For instance, you might find that the constraints of a loan can be avoided if the inter-family money exchange falls below the annual gift tax threshold.

Other tax-free exclusions can be made for canceled debts that involve the borrower's main home or mortgage, particularly for those who had their mortgage debt canceled in 2016. Additional exclusions might apply to loans associated with second homes, rental or business property, credit card debt, or car loans. For instance, if the taxpayer is insolvent both before and after the debt forgiveness, then the debt will not be taxable.

However, it's usually up to you — the taxpayer — to prove these circumstances should cancel your debt. Don't assume the IRS will turn a blind eye when a loan is forgiven and also don't assume the IRS will consider these exclusions without your persistence.

Steven Bankler has more than 42 years of experience in the accounting industry. Steven's expertise lies in consulting, planning, tax, and asset protection as well as exit strategy services for closely-held businesses. He also provides litigation support (both as a testifying expert witness and a consulting expert), business negotiations and estate planning. Visit www.bankler.com for additional tax strategy tips and to learn more about Steven Bankler, CPA, Ltd.

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