Deduct a loss from making a personal loan to a relative or friend

Suppose your adult child or friend needs to borrow money. Maybe it's to buy a first home or address a cash flow problem. You may want to help by making a personal loan. That's a nice thought, but there are tax implications that you should understand and take into account.

Get it in writing

You want to be able to prove that you intended for the transaction to be a loan rather than an outright gift. That way, if the loan goes bad, you can claim a *non-business bad debt deduction* for the year the loan becomes worthless.

For federal income tax purposes, losses from personal loans are classified as *short-term capital losses.* You can use the losses to first offset short-term capital gains that would otherwise be taxed at high rates. Any remaining net short-term capital losses will offset any net long-term capital gains. After that, any remaining net capital losses can offset up to $3,000 of high-taxed ordinary income ($1,500 if you use married filing separate status).

To pass muster with the IRS, your loan should be evidenced by a written promissory note that includes:

- The interest rate, if any,
- A schedule showing dates and amounts for interest and principal payments, and

- The security or collateral, if any.

Set the interest rate

Applicable federal rates (AFRs) are the minimum short-term, mid-term and long-term rates that you can charge without creating any unwanted tax side effects. AFRs are set by the IRS, and they can potentially change every month.

For a *term loan* (meaning one with a specified final repayment date), the relevant AFR is the rate in effect for loans of that duration for the month you make the loan. Here are the AFRs for term loans made in April of 2025:

- For a loan with a term of three years or less, the AFR is 4.09%, assuming monthly compounding of interest.
- For a loan with a term of more than three years but not more than nine years, the AFR is 4.13%.
- For a loan with a term of more than nine years, the AFR is 4.52%.

Key point: These are lower than commercial loan rates, and the same AFR applies for the life of the loan.

For example, in April of 2025, you make a $300,000 loan with an eight-year term to your daughter so she can buy her first home. You charge an interest rate of exactly 4.13% with monthly compounding (the AFR for a mid-term loan made in April). This is a good deal for your daughter!

Interest rate and the AFR

The federal income tax results are straightforward if your loan charges an interest rate that equals or exceeds the AFR. You must report the interest income on your Form 1040. If the loan is used to buy a home, your borrower can potentially treat the interest as deductible qualified residence interest if you secure the loan with the home.

What if you make a below-market loan (one that charges an interest rate below the AFR)? The Internal Revenue Code treats you as making an *imputed gift* to the borrower. This imaginary gift equals the difference between the AFR interest you “should have” charged and the interest you charged, if any. The borrower is then deemed to pay these phantom dollars back to you as *imputed interest income.* You must report the imputed interest income on your Form 1040. A couple of loopholes can potentially get you out of this imputed interest trap. We can explain the details.

Plan in advance

As you can see, you can help a relative or friend by lending money and still protect yourself in case the personal loan goes bad. Just make sure to have written terms and charge an interest rate at least equal to the AFR. If you charge a lower rate, the tax implications are not so simple. If you have questions or want more information about this issue, contact us.