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Oops, Interest-Free Loans Are Taxable

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Suppose your employer loans you money, and like a good employee, you repay it. Neither event is taxable. But paying ***interest*** has tax effects to you both. What if you agree there's ***no*** interest?

Not so fast. The IRS can impute it even if even if you expressly ***agreed*** there would be no interest. The rules regarding interest run throughout the tax code. In many circumstances even if you state something is "interest free" it isn't.

For example, suppose you buy property promising to pay in a year with no interest? The IRS generally treats the sale as for a lower price with interest added. In effect, the IRS "attributes" interest even when the parties don't intend—and don't want—it. That way the seller can't treat it all as capital gain and instead must treat part of the money as interest taxed as ordinary income.

Loans are similar, and there's even the concept of below-market rates. In effect, the IRS polices the interest rates charged to make sure it is within market rates. Even if you navigate all this, you need to consider when any debt—including interest—is forgiven.

Forgiven principal or interest triggers another set of rules: discharge of indebtedness, also called cancellation of debt income, often shortened to ***COD income***. See Ten Things To Know About COD Income. When a debt you owe is canceled, the tax code usually treats the wiped out debt as income to you. If you owe $500,000 to the bank but the bank forgives it, it's as if the bank just handed you $500,000. Uncle Sam wants his cut.

There are other types of phantom income that incur a tax despite the fact that you've gotten no cash. However, after 30 years as a tax lawyer, I'd rank COD income one of the biggest tax traps. The good news is that there are exceptions that may keep you from having to write a check to the IRS. For a list of exceptions, see Ten Things To Know About COD Income.

These situations can be especially messy when loans are used to keep employees. In the recent case of *Brooks v. Commissioner*, Brooks received a loan from his employer. The employer promised to forgive it, including all interest if Brooks stayed employed for five years. He did and his employer forgave the loan.

That meant Brooks was taxed on the forgiven loan principal and accrued interest. Brooks went to Tax Court arguing the forgiven interest wasn't taxable after all. He argued he shouldn't have discharge of debt income since he would have been able to deduct the interest if he had actually paid it.

Nope, said the Tax Court. The interest the employer forgave was income, period.

For more, see:

When "Loans" Are Taxed As Income

Home Foreclosures And Tax Returns

Short Sale Tax Problems

Home Foreclosures And Tax Returns

When You've Got Taxable Income But No Cash

IRS Tax Topic Topic 431 – Canceled Debt – Is it Taxable or Not?

IRS Publication 4681 Canceled Debts, Foreclosures, Repossessions, and Abandonments

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