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Abstract: If a relative needs financial help, offering an intrafamily loan might seem like a good idea. But if not properly executed, such loans can carry negative tax consequences. This article presents five simple steps that would-be lenders should consider before making such an arrangement.

5 tips for safe intrafamily loans

If a relative needs financial help, offering an intrafamily loan might seem like a good idea. But if not properly executed, such loans can carry negative tax consequences — such as unexpected taxable income, gift tax or both. Here are five tips to help avoid any unwelcome tax surprises:

1. Create a paper trail. In general, to avoid undesirable tax consequences, you need to be able to show that the loan was bona fide. To do so, document evidence of:

- The amount and terms of the debt,
- Interest charged,
- Fixed repayment schedules,
- Collateral,
- Demands for repayment, and
- The borrower's solvency at the time of the loan.

Be sure to make your intentions clear — and help avoid loan-related misunderstandings — by also documenting the loan payments received.

2. Demonstrate an intention to collect. Even if you think you may eventually forgive the loan, ensure the borrower makes at least a few payments. By having some repayment history, you'll make it harder for the IRS to argue that the loan was really an outright gift. And if a would-be borrower has no realistic chance of repaying a loan, don't make it. If you're audited, the IRS is sure to treat such a loan as a gift.

3. Charge interest if the loan exceeds $10,000. If you lend more than $10,000 to a relative, charge at least the applicable federal interest rate (AFR). Be aware that interest on the loan will be taxable income to you. If no or below-AFR interest is charged, taxable interest is calculated under the complicated below-market-rate loan rules. In addition, all of the forgone interest over the term of the loan may have to be treated as a gift in the year the loan is made. This will increase your chances of having to use some of your lifetime exemption.

4. Use the annual gift tax exclusion. If you want to, say, help your daughter buy a house but don't want to use up any of your lifetime gift and estate tax exemption, you can make the loan and charge interest and then forgive the interest, the principal payments or both each year under the annual gift tax exclusion. For 2020, you can forgive up to $15,000 per borrower ($30,000 if your spouse joins in the gift) without paying gift taxes or using any of your lifetime exemption. But you will still have interest income in the year of forgiveness.

5. Forgive or file suit. If an intrafamily loan that you intended to collect is in default, don't let it sit too long. To prove this was a legitimate loan that soured, you'll need to take appropriate legal steps toward collection. If you know you'll never collect and don't want to file suit, begin forgiving the loan using the annual gift tax exclusion, if possible.

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