Abstract: Lending money to family members may be personal, but it pays to treat loans like business. Otherwise, the “lender” could owe taxes on income he or she never received and gifts he or she never intended to make. Structured properly, however, an intrafamily loan can be a great way to help family members buy a home, start a business or meet any number of financial needs. It can also be an effective estate planning tool. This article reviews the ins and outs of intrafamily loans, including documentation and interest rates.

Generating interest with intrafamily loans

Lending money to family members may be personal, but it pays to treat loans like business. If you don’t, you could owe taxes on income you never received and gifts you never intended to make.

Structured properly, however, an intrafamily loan can be a great way to help your kids or other family members buy a home, start a business or meet any number of financial needs. It can also be an effective estate planning tool for you.

The importance of documentation

Regardless of your loan’s terms, it’s important to put it in writing. The IRS is likely to view an undocumented loan to a family member as a gift, which may eat up some of your lifetime gift tax exemption (currently $1 million) or create a taxable gift if you’ve already used your lifetime exemption.

To avoid this result, document the loan with a promissory note. It should outline the terms of repayment, including when payments are due, and the interest rate for the loan.

A higher rate’s advantage

It may be tempting to offer your loved ones low-interest or even no-interest loans, but there can be significant tax advantages to charging a higher rate. If you lend money to family members at less than the applicable federal rate (AFR), the shortfall will be imputed to you.

In other words, you’ll be treated as if you’d charged the borrower the AFR, and that amount will be included in your taxable income — whether or not you collect it. What’s more, this forgone interest will be treated as a taxable gift to the borrower. The borrower may be able to deduct the interest, depending on the purpose of the loan.

Two loan options

Two exceptions allow you to make no-interest or low-interest intrafamily loans without generating imputed interest:

1. The $10,000 exception. You can lend a family member up to $10,000 without negative tax consequences, provided the money isn't invested in income-producing assets. For example, you could make a $10,000 interest-free loan to your daughter for a down payment on a condo. But the exception won't apply if she puts the money in a savings account.

2. The $100,000 exception. Imputed interest on family loans up to $100,000 is limited to the borrower's net investment income and is eliminated if net investment income is $1,000 or less. Thus, in such situations, there is no taxable gift for the forgone interest.

Gift calculations

Gifts are calculated differently depending on the type of loan. If the loan is a term loan, for instance, you can calculate the gift as the difference between the present value of the forgone interest for the life of the loan and the present value of the loan's stated interest. For a demand loan, the gift is recalculated annually based on the forgone interest for that year.

With a demand loan, there is the opportunity to take advantage of the annual gift tax exclusion each year. (The annual gift tax exclusion allows you to give up to $13,000 annually to a relative or friend gift-tax free.) On the other hand, if you exceed your annual gift tax exclusion in the year of a term loan, you'll have to use some of your lifetime gift tax exemption, which is $1 million in 2010.

Estate tax benefits

In addition to helping out your loved ones, an intrafamily loan can also be a tax-efficient tool for removing wealth from your estate.

(Note that, although an estate tax repeal went into effect Jan. 1, 2010, the estate tax is scheduled to return in 2011. Congress may even take action to repeal the repeal, perhaps retroactively to Jan. 1. Check with your tax advisor for the latest information.)

Let's look at an example.

David lends $200,000 to his daughter, Mary, charging 5% interest (the long-term AFR for the month he made the loan). Because the interest rate is equal to the AFR, there is no imputed interest for income or gift tax purposes. The note provides for payments of interest for 20 years, with the principal due at the end of the term. Mary invests the money in mutual funds that yield an 8% annual return.

At the end of the term, the funds have grown to more than $930,000. Mary pays David the $200,000 principal, which is included in his estate. But the remaining $730,000 passes to Mary outside David's estate, generating substantial tax savings.

To further assist Mary, David could forgive some or all of her $10,000 interest payments. Although he would still have to include the interest in his income, the forgiven payments would qualify as tax-free gifts under the annual gift tax exclusion.

Complex rules, costly missteps

Intrafamily loans provide many benefits for both lenders and borrowers. But the imputed interest rules are complex, and missteps can be costly. Plan carefully to structure a loan that meets your needs and avoids unintended consequences.

Sidebar: Pay more than lip service

Documenting a loan is one thing. Actually adhering to its terms is another. To make sure the IRS doesn't characterize a loan as a disguised gift, treat it as a legitimate transaction: Require regular payments and make a genuine effort to collect if the borrower defaults. Also, be sure to document receipt of payments and collection efforts.

Should you ever want to write off the loan as a bad debt, this evidence will help you demonstrate that the transaction was a bona fide loan gone bad and not a gift.

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