WIGGIN
WIGGIN AND DANA

ADVISORY

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If you have any questions about this Advisory, please contact **pcs@wiggin.com**

About the Private Client Services Department

Experience the boutique feel of Wiggin and Dana's Private Client Services team, which includes over four dozen skilled lawyers and dedicated staff members conveniently located in the communities where our clients live and work.

Backed by a full-service law firm with a global reach, we are adeptly positioned to handle a wide range of complex issues while providing personalized attention that our clients appreciate.

LOANING MONEY TO FAMILY: A GUIDE TO INTRAFAMILY LOANS

Clients interested in assisting a family member financially can consider making an intrafamily loan. To be respected as a loan, rather than a gratuitous transfer, certain formalities should be followed. Here, we outline those formalities.

WHAT IS AN INTRAFAMILY LOAN?

Although current tax law allows for the exclusion of gifts up to $13.99 million for individuals and $27,980,000 million for married couples, intrafamily loans may still be a preferable option as they provide additional benefits to both the lender and borrower.

Intrafamily loans provide more flexibility than traditional commercial loans. As a lender, you are generally free to structure the terms of the loan to reflect the circumstances and needs of the borrower. While family lenders must charge a minimum interest rate on the loan equal to or greater than the Applicable Federal Rate (AFR), this minimum rate can be charged regardless of the borrower's creditworthiness and is often lower than the rates offered on commercial loans.

Intrafamily loans also achieve the lender's goal of transferring wealth to family members without reducing the lender's estate tax exemption. For example, if you loan your child funds to establish an investment portfolio and the portfolio grows at a rate greater than the interest rate charged on the loan, you would have transferred a portion of the growth on the loaned funds to your child without using any of your lifetime gift and estate tax exemption.

Intrafamily loans may be used for a variety of purposes, including assisting relatives in:

- purchasing shares of a family business;
- purchasing a residence;
- funding a business venture;
- investing in any other asset; and
- paying down high-interest debt.

To ensure that an intrafamily loan is executed properly, clients should follow these important guidelines:

1. Charge a Minimum Interest Rate

An intrafamily loan must bear interest at a rate equal to or greater than the AFR in order for the loan to not be considered a taxable gift. The AFR for each month—which is published by the IRS on or around the 20th day of the preceding month—is broken into three tiers depending on the term of the loan.

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The short-term rate applies to loans of up to three years, the mid-term rate applies to loans with a term between three and up to nine years, and the long-term rate applies to loans with repayment terms of greater than nine years.

The rates for May 2025 are:

- Short-Term – 4.05%
- Mid-Term – 4.10%
- Long-Term – 4.62%

2. Select the Right Payment Structure

While loans may be structured in a variety of ways, clients often select one of the following three types of payment terms:

Interest Only Payments. Under this arrangement, the borrower pays interest on an annual basis to the lender and makes a balloon payment of principal at the end of the payment term.

Amortized Payments. Here, the borrower pays a specific monthly amount designed to pay off the interest and principal amount throughout the term of the loan. This plan generally costs the borrower the least amount of interest.

Accrued Interest. With this type of loan, the interest on the loan is not paid currently, but is instead added to the principal amount due on an annual basis. All interest and principal are due at the end of the term of the loan. This plan generally costs the borrower the most amount of interest.

Note that the interest cost difference between each strategy becomes more pronounced as interest rates rise. When selecting a payment structure, clients should consider the overall goal for using the loan and the borrower's needs and circumstances.

3. Consider Requiring Security

Clients should consider requiring security to ensure repayment of the loan to best protect their interest in the note. For example, where an intrafamily loan is used to purchase real estate, clients should consider placing a mortgage on the property. The mortgage would:

- protect the property from claims of the borrower's creditors or divorcing spouses;
- benefit the lender if the borrower attempts to refinance the mortgage through traditional banking methods; and
- permit the borrower to deduct the interest expense on their personal income tax returns.

4. Consider the Repercussions of Loan Forgiveness

It is not uncommon that lenders of intrafamily loans will want to forgive a portion of the note from time to time. This can be an effective strategy so long as clients are aware of the following:

Effect on Income Tax Liability. When a lender forgives interest on a promissory note, that lender must still recognize the forgone interest as income.

Effect on Gift Tax Liability. For an intrafamily loan to not be considered a taxable gift, there cannot be any implication of a prearranged agreement for the lender to forgive the borrower's interest or principal payments. Clients can avoid this by ensuring that the forgiveness is in the lender's absolute discretion, and that the note is both subject to seizure by the lender's creditors, and enforceable against the borrower by the lender's estate if the lender dies during the term of the loan. These terms should be well-documented. The IRS will consider any amount forgiven that exceeds the annual gift tax exclusion (currently $19,000) as a taxable gift, which will count against the lender's lifetime gift and estate tax exemption.

5. Consider the Benefits of Note Refinancing When the AFR is Low

For clients with existing intrafamily promissory notes, if the terms of the original loan permit a prepayment of the promissory note at any time without penalty, then the lender may be able to reissue a replacement promissory note that takes advantage of lower interest rates.

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6. Document the Terms and Intention of the Loan

Although intrafamily loans are significantly less formal than traditional commercial loans, it is important to maintain a formal loan documentation process. Given that the IRS will generally assume that any transfer of money between family members is a gift, it is important to have documents reflecting that the lender and borrower intended the transfer to be a loan. Borrowers and lenders should sign a promissory note that adheres to state-specific rules, and which includes the following:

- the payment structure of the loan (i.e., the interest rate, the schedule of principal and interest repayments, and the maturity date);
- any security to ensure repayment of the loan; and
- the terms for loan forgiveness.

If the loan is secured by any collateral, there should be an accompanying security agreement or other document.

7. Conduct Yourselves as if the Transaction Were a Loan

It is not enough to execute a promissory note; the parties should generally conduct themselves to show a proper debtor-creditor relationship by adhering to the terms of the note. The borrower should make the payments required under the note and the parties should have written evidence of the actual payments made under the promissory note. In the event that the borrower fails to make the required payments, the lender should attempt to collect on any defaulted loan payments.

NEXT STEPS?

While intrafamily loans can be a tax-efficient way to transfer wealth to relatives, they also require proper consideration and planning. We can help you determine whether this is an appropriate strategy given the current AFR, family dynamics, and the circumstances of the loan.

If you have any questions or would like to pursue this planning strategy, please contact your **Wiggin and Dana attorney**.